

# CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 1 of 307

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## Table of Contents

<b>CHAPTER 1 INTRODUCTION TO ECONOMIC DEVELOPMENT AREAS</b>	<b>13</b>
a. Introduction	13
b. Expired Economic Development Areas	14
c. Geographic Boundaries	15
d. Enterprise Zone Locations and Designation Dates	15
e. LAMBRA Locations and Designation Dates	17
f. MEA Locations and Designation Dates	17
g. TTA Locations and Designation Date	17
h. LARZ Locations and Designation Dates	18
i. Program Area Locations and Designation Dates	19
j. Tax Incentives	19
k. References	20
<b>CHAPTER 2 ENTERPRISE ZONE HIRING CREDIT</b>	<b>22</b>
a. Introduction	22
b. Qualified Taxpayer	22
c. Qualified Wages	23
d. Qualified Employee	25
e. Vouchering Form TCA EZ1	27
f. Credit Computation	27
g. Reduction for Other Tax Credits	28
h. Wage Expense Reduction	28
i. Business Income Activity Limitation	28
j. General Provisions – Apportionment of Business Income	29
(i) Property Factor – Income Apportionment	30
(ii) Payroll Factor – Income Apportionment	31
(iii) Sales Factor – Income Apportionment	31
(iv) Apportionment – Combined Groups	32
(v) Apportioning for Personal Income Tax Taxpayers	33
k. S Corporations	34
l. Credit Usage & Carryover	35
m. Credit Will Not Reduce Certain Taxes	36
n. Credit Recapture	36
o. Record Keeping Requirements	37
<b>CHAPTER 3 ENTERPRISE ZONE SALES OR USE TAX CREDIT</b>	<b>38</b>
a. Introduction	38

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 2 of 307

b. Multiple Credits allowed .....	39
c. Qualified Taxpayer .....	39
d. Qualified Property .....	39
e. Credit Computation – Asset Value Limitation .....	40
f. Depreciable Basis .....	41
g. Business Income Activity Limitation.....	41
h. General Provisions – Apportionment of Business Income .....	42
(i) Property Factor – Income Apportionment .....	43
(ii) Payroll Factor – Income Apportionment .....	43
(iii) Sales Factor – Income Apportionment .....	43
(iv) Apportionment – Combined Groups.....	44
(v) Apportioning for Personal Income Tax Taxpayers .....	46
i. S Corporation & Shareholder Credit Amounts .....	47
j. Sales or Use Tax Credit and the Hiring Credit.....	48
k. Credit Usage and Carryover.....	48
l. Credit Will Not Reduce Certain Taxes .....	49
m. Depreciation .....	49
n. Credit Recapture .....	49
o. Record Keeping Requirements.....	49
<b>CHAPTER 4 ENTERPRISE ZONE BUSINESS EXPENSE</b>	
<b>DEDUCTION .....</b>	<b>51</b>
a. Introduction .....	51
b. Qualified Taxpayer .....	51
c. Qualified Property .....	52
d. Property Not Qualified .....	52
e. Deduction Amount .....	53
f. Basis reduction .....	54
g. Interaction With The Manufacturers' Investment Credit .....	54
h. Election .....	54
i. Depreciation .....	55
j. Creating a Net Operating Loss.....	55
k. Alternative Minimum Tax.....	55
l. Recapture.....	55
m. Checklist for Determining Eligibility For the Business Expense Deduction.....	56
n. Record Keeping Requirements.....	57
<b>CHAPTER 5 ENTERPRISE ZONE NET OPERATING LOSS.....</b>	<b>58</b>
a. Introduction .....	58
b. Qualified Taxpayer .....	59
c. Election .....	59
d. EZ NOL Computation - General Provisions .....	59
e. EZ NOL - Loss Attributed to Business Activity .....	60

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

(i)	Property Factor – Loss Apportionment .....	61
(ii)	Payroll Factor – Loss Apportionment .....	61
(iii)	Sales Factor – Loss Apportionment .....	61
(iv)	Apportionment – Combined Groups .....	62
(v)	Apportioning for Personal Income Tax Taxpayers .....	63
<b>f.</b>	<b>EZ NOL Limited by General NOL .....</b>	<b>64</b>
<b>g.</b>	<b>Carryover / Carryback .....</b>	<b>65</b>
<b>h.</b>	<b>NOL Deduction - General Provisions .....</b>	<b>66</b>
(i)	Income Attributed to Business Activity .....	66
(ii)	Property Factor – Income Apportionment .....	67
(iii)	Payroll Factor – Income Apportionment .....	67
(iv)	Sales Factor – Income Apportionment .....	67
(v)	Apportionment – Combined Groups .....	68
(vi)	Apportioning for Personal Income Tax Taxpayers .....	70
<b>i.</b>	<b>NOL Suspensions .....</b>	<b>71</b>
<b>j.</b>	<b>S Corporations .....</b>	<b>71</b>
<b>k.</b>	<b>Alternative Minimum Tax .....</b>	<b>71</b>
<b>l.</b>	<b>Flow-through Losses .....</b>	<b>71</b>
<b>CHAPTER 6 ENTERPRISE ZONES NET INTEREST DEDUCTION .....</b>		<b>72</b>
<b>a.</b>	<b>Introduction .....</b>	<b>72</b>
<b>b.</b>	<b>Qualified Taxpayer .....</b>	<b>72</b>
<b>c.</b>	<b>Qualified Debt .....</b>	<b>73</b>
<b>d.</b>	<b>Net Interest Deduction - Computation .....</b>	<b>74</b>
<b>e.</b>	<b>Expiration Of EZ Designation .....</b>	<b>77</b>
<b>f.</b>	<b>Record Keeping .....</b>	<b>77</b>
<b>CHAPTER 7 ENTERPRISE ZONE EMPLOYEE WAGE CREDIT .....</b>		<b>79</b>
<b>a.</b>	<b>Introduction .....</b>	<b>79</b>
<b>b.</b>	<b>Qualified Employee .....</b>	<b>79</b>
<b>c.</b>	<b>Qualified Wages .....</b>	<b>79</b>
<b>d.</b>	<b>Credit Limitations &amp; Income Limitation .....</b>	<b>79</b>
<b>CHAPTER 8 TARGETED TAX AREA HIRING CREDIT .....</b>		<b>81</b>
<b>a.</b>	<b>Introduction .....</b>	<b>81</b>
<b>b.</b>	<b>Qualified Taxpayer .....</b>	<b>81</b>
<b>c.</b>	<b>Qualified Wages .....</b>	<b>82</b>
<b>d.</b>	<b>Qualified Employee .....</b>	<b>83</b>
<b>e.</b>	<b>Vouchering Form TCA TTA1 .....</b>	<b>85</b>
<b>f.</b>	<b>Credit Computation .....</b>	<b>85</b>
<b>g.</b>	<b>Credit Limitation - Exclusive Credit .....</b>	<b>86</b>
<b>h.</b>	<b>Wage Expense Reduction .....</b>	<b>86</b>
<b>i.</b>	<b>Business Income Activity Limitation .....</b>	<b>86</b>
<b>j.</b>	<b>General Provisions – Apportionment of Business Income .....</b>	<b>87</b>

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 4 of 307

(i)	Property Factor – Income Apportionment .....	87
(ii)	Payroll Factor – Income Apportionment .....	88
(iii)	Apportionment – Combined Groups .....	88
(iv)	Apportioning for Personal Income Tax Taxpayers .....	89
k.	<b>S Corporations .....</b>	<b>90</b>
l.	<b>Credit Usage &amp; Carryover .....</b>	<b>91</b>
m.	<b>Credit Will Not Reduce Certain Taxes .....</b>	<b>92</b>
n.	<b>Credit Recapture .....</b>	<b>92</b>
o.	<b>Record Keeping Requirements .....</b>	<b>93</b>
<b>CHAPTER 9 TARGETED TAX AREA SALE OR USE TAX</b>		
<b>CREDIT .....</b>		<b>95</b>
a.	<b>Introduction .....</b>	<b>95</b>
b.	<b>Exclusive Credit .....</b>	<b>95</b>
c.	<b>Qualified Taxpayer .....</b>	<b>95</b>
d.	<b>Qualified Property .....</b>	<b>96</b>
e.	<b>Credit Computation – Asset Value Limitation .....</b>	<b>97</b>
f.	<b>Depreciable Basis .....</b>	<b>97</b>
g.	<b>Business Income Activity Limitation .....</b>	<b>98</b>
h.	<b>General Provisions – Apportionment of Business Income .....</b>	<b>99</b>
(i)	Property Factor – Income Apportionment .....	99
(ii)	Payroll Factor – Income Apportionment .....	99
(iii)	Apportionment – Combined Groups .....	100
(iv)	Apportioning for Personal Income Tax Taxpayers .....	101
i.	<b>S Corporation &amp; Shareholder Credit Amounts .....</b>	<b>102</b>
j.	<b>Sales Or Use Tax Credit And The Hiring Credit .....</b>	<b>103</b>
k.	<b>Credit Usage and Carryover .....</b>	<b>103</b>
l.	<b>Credit Will Not Reduce Certain Taxes .....</b>	<b>104</b>
m.	<b>Depreciation .....</b>	<b>104</b>
n.	<b>Credit Recapture .....</b>	<b>105</b>
o.	<b>Record Keeping Requirements .....</b>	<b>105</b>
<b>CHAPTER 10 TARGETED TAX AREA BUSINESS EXPENSE</b>		
<b>DEDUCTION .....</b>		<b>106</b>
a.	<b>Introduction .....</b>	<b>106</b>
b.	<b>Qualified Taxpayer .....</b>	<b>106</b>
c.	<b>Qualified Property .....</b>	<b>107</b>
d.	<b>Property Not Qualified .....</b>	<b>107</b>
e.	<b>Deduction Amount .....</b>	<b>108</b>
f.	<b>Basis Reduction .....</b>	<b>108</b>
g.	<b>Interaction with the Manufacturer's Investment Credit .....</b>	<b>108</b>
h.	<b>Election .....</b>	<b>109</b>
i.	<b>Depreciation .....</b>	<b>109</b>
j.	<b>Creating a Net Operating Loss .....</b>	<b>109</b>

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

k. Alternative Minimum Tax.....	110
l. Recapture.....	110
m. Checklist To Determine Eligibility for the Business Expense Deduction.....	110
n. Record Keeping Requirements.....	111
<b>CHAPTER 11 TARGETED TAX AREA NET OPERATING LOSS</b>	
.....	112
a. Introduction .....	112
b. Qualified Taxpayer .....	112
c. Election .....	113
d. TTA NOL Computation - General Provisions .....	113
e. TTA NOL - Loss Attributed to Business Activity .....	113
(i) Property Factor – Loss Apportionment .....	114
(ii) Payroll Factor – Loss Apportionment .....	114
(iii) Apportionment – Combined Groups.....	115
(iv) Apportioning for Personal Income Tax Taxpayers .....	116
f. TTA NOL Limited by General NOL .....	117
g. Carryover / Carryback.....	118
h. TTA NOL Deduction - General Provisions .....	118
(i.) Income Attributed to Business Activity .....	119
(ii) Property Factor – Income Apportionment .....	119
(iii) Payroll Factor – Income Apportionment .....	119
(iv) Apportionment – Combined Groups.....	120
(v) Apportioning for Personal Income Tax Taxpayers .....	121
i. S Corporations .....	122
j. Alternative Minimum Tax.....	122
k. Flow-through Losses .....	122
<b>CHAPTER 12 LOCAL AGENCY MILITARY BASE RECOVERY AREA HIRING CREDIT</b>	
.....	123
a. Introduction .....	123
b. Qualified Taxpayer .....	123
c. Qualified Wages .....	124
d. Qualified Employee.....	126
e. Credit Computation.....	128
f. Wage Expense Deduction .....	129
g. Business Income Activity Limitation.....	129
h. General Provisions – Apportionment of Business Income .....	130
(i) Property Factor – Income Apportionment .....	130
(ii) Payroll Factor – Income Apportionment .....	131
(iii) Apportionment – Combined Groups.....	132
(iv) Apportioning for Personal Income Tax Taxpayers .....	133
i. S Corporations .....	134

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 6 of 308

j. Credit Usage & Carryover.....	135
k. Credit Will Not Reduce Certain Taxes .....	135
l. Credit Recapture .....	136
m. Record Keeping Requirements .....	141
<b>CHAPTER 13 LOCAL AGENCY MILITARY BASE RECOVERY</b>	
<b>AREA (LAMBRA) SALES OR USE TAX CREDIT .....</b>	<b>143</b>
a. Introduction .....	143
b. Exclusive Credit .....	143
c. "Taxpayer" Defined .....	143
d. Qualified Property .....	144
e. Credit Computation – Asset Value Limitation .....	144
f. Depreciable Basis .....	145
g. Business Income Activity Limitation.....	145
h. General Provisions – Apportionment of Business Income .....	146
(i) Property Factor – Income Apportionment.....	147
(ii) Payroll Factor – Income Apportionment.....	147
(iii) Apportionment – Combined Groups.....	148
(iv) Apportioning for Personal Income Tax Taxpayers .....	149
i. S Corporation & Shareholder Credit Amounts .....	151
j. Sales or Use Tax Credit and the Hiring Credit.....	151
k. Credit Usage and Carryover.....	152
l. Credit Will Not Reduce Certain Taxes .....	152
m. Depreciation .....	153
n. Credit Recapture .....	153
o. Record Keeping Requirements.....	158
<b>CHAPTER 14 LOCAL AGENCY MILITARY BASE RECOVERY</b>	
<b>AREA BUSINESS EXPENSE DEDUCTION.....</b>	<b>159</b>
a. Introduction .....	159
b. "Taxpayer" Defined.....	159
c. Qualified Property .....	160
d. Property Not Qualified .....	160
e. Deduction Amount .....	161
f. Basis reduction .....	162
g. Interaction with the Manufacturer's Investment Credit.....	162
h. Election .....	162
i. Depreciation .....	163
j. Creating a Net Operating Loss.....	163
k. Alternative Minimum Tax.....	163
l. Recapture.....	163
m. Checklist To Determine Eligibility for the Business Expense Deduction.....	168
n. Record Keeping Requirements.....	169

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 7 of 307

### CHAPTER 15 LOCAL AGENCY MILITARY BASE RECOVERY

<b>AREA NET OPERATING LOSS .....</b>	<b>170</b>
a. Introduction .....	170
b. Qualified Taxpayer .....	170
c. Election .....	171
d. LAMBRA NOL Computation - General Provisions .....	171
e. LAMBRA NOL - Loss Attributed to Business Activity .....	172
(i) Property Factor – Loss Apportionment .....	172
(ii) Payroll Factor – Loss Apportionment .....	172
(iii) Apportionment – Combined Groups.....	173
(iv) Apportioning for Personal Income Tax Taxpayers .....	174
f. LAMBRA NOL Limited by General NOL .....	175
g. Carryover / Carryback.....	176
h. LAMBRA NOL Deduction - General Provisions .....	177
(i) Income Attributed to Business Activity .....	177
(ii) Property Factor – Income Apportionment .....	177
(iii) Payroll Factor – Income Apportionment .....	178
(iv) Apportionment – Combined Groups.....	179
(v) Apportioning for Personal Income Tax Taxpayers .....	180
i. Net Increase in Jobs Requirement .....	181
j. S Corporations .....	185
k. Alternative Minimum Tax.....	185
l. Flow-through Losses .....	185

### CHAPTER 16 MANUFACTURING ENHANCEMENT AREA

<b>HIRING CREDIT.....</b>	<b>186</b>
a. Introduction .....	186
b. Qualified Taxpayer .....	186
c. Qualified Wages .....	187
d. Qualified Employee .....	188
e. Credit Computation.....	189
f. Credit Adjustments & Limitations .....	190
g. Wage Expense Reduction .....	191
h. Business Income Activity Limitation.....	191
i. General Provisions – Apportionment of Business Income .....	192
(i) Property Factor – Income Apportionment .....	192
(ii) Payroll Factor – Income Apportionment .....	192
(iii) Apportionment – Combined Groups.....	193
(iv) Apportioning for Personal Income Tax Taxpayers .....	194
j. S Corporations .....	196
k. Credit Usage & Carryover.....	196
l. Credit Will Not Reduce Certain Taxes .....	197
m. Credit Recapture.....	197

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 8 of 307

n. Record Keeping Requirements.....	199
<b>CHAPTER 17 LOS ANGELES REVITALIZATION ZONE HIRING CREDIT.....</b>	<b>200</b>
a. Introduction .....	200
b. Taxpayer Defined – General & Construction Hiring Credits.....	201
c. General Hiring Credit .....	202
(i.) Qualified Wages.....	202
(ii.) Qualified Employee - General Hiring Credit .....	203
(iii.) Credit Computation -General Hiring Credit .....	204
(iv.) Reduction for Other Tax Credits – General Hiring Credit .....	205
d. Construction Hiring Credit.....	205
(i.) Qualified Wages.....	205
(ii.) Qualified Employee-Construction Hiring Credit .....	206
(iii.) Credit Computation-Construction Hiring Credit .....	207
(iv.) Reduction for Other Tax Credits – Construction Hiring Credit.....	207
e. Minimum Wage Chart.....	208
f. Wage Expense Deduction .....	208
g. Business Income Activity Limitation .....	208
h. General Provisions – Apportionment of Business Income .....	209
(i) Property Factor – Income Apportionment.....	210
(ii) Payroll Factor – Income Apportionment .....	210
(iii) Apportionment – Combined Groups.....	211
(iv) Apportioning for Personal Income Tax Taxpayers .....	212
i. S Corporations .....	214
j. Credit Usage & Carryover.....	214
k. Credit Will Not Reduce Certain Taxes .....	215
l. Credit Recapture .....	216
m. Record Keeping .....	217
<b>CHAPTER 18 LOS ANGELES REVITALIZATION ZONE SALES OR USE TAX CREDIT .....</b>	<b>218</b>
a. Introduction .....	218
b. Exclusive Credit .....	219
c. "Taxpayer" Defined.....	219
d. Qualified Property .....	219
e. Credit Computation.....	219
f. Depreciable Basis .....	220
g. Business Income Activity Limitation.....	220
h. General Provisions – Income Apportionment .....	221
(i) Property Factor – Income Apportionment.....	222
(ii) Payroll Factor – Income Apportionment .....	222
(iii) Apportionment – Combined Groups.....	223
(iv) Apportioning for Personal Income Tax Taxpayers .....	224

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 9 of 307

i. S Corporation & Shareholder Credit Amounts .....	225
j. Sales or Use Tax Credit and the Hiring Credit.....	226
k. Credit Usage and Carryover.....	226
l. Credit Will Not Reduce Certain Taxes .....	227
m. Depreciation .....	228
n. Credit Recapture .....	228
o. Record Keeping Requirements.....	228
<b>CHAPTER 19 LOS ANGELES REVITALIZATION ZONE</b>	
<b>BUSINESS EXPENSE DEDUCTION.....</b>	<b>230</b>
a. Introduction .....	230
b. Taxpayer Defined .....	231
c. Qualified Property .....	231
d. Property Not Qualified .....	231
e. Deduction Amount .....	232
f. Basis reduction .....	232
g. Interaction with the Manufacturer's Investment Credit.....	232
h. Election .....	232
i. Depreciation .....	233
j. Creating a Net Operating Loss.....	233
k. Alternative Minimum Tax.....	233
l. Recapture.....	233
m. Checklist To Determine Eligibility for the Business Expense Deduction.....	234
n. Record Keeping Requirements.....	235
<b>CHAPTER 20 LOS ANGELES REVITALIZATION ZONE NET</b>	
<b>OPERATING LOSS .....</b>	<b>236</b>
a. Introduction .....	236
b. Qualified Taxpayer .....	237
c. Election .....	237
d. LARZ NOL Computation - General Provisions .....	238
e. LARZ NOL - Loss Attributed to Business Activity .....	238
(i) Property Factor – Loss Apportionment .....	239
(ii) Payroll Factor – Loss Apportionment .....	239
(iii) Apportionment – Combined Groups.....	240
(iv) Apportioning for Personal Income Tax Taxpayers .....	241
f. LARZ NOL Limited by General NOL .....	242
g. Carryover / Carryback.....	243
h. LARZ NOL Deduction - General Provisions.....	243
(i) Income Attributed to Business Activity.....	244
(ii) Property Factor – Income Apportionment .....	244
(iii) Payroll Factor – Income Apportionment.....	245
(iv) Apportionment – Combined Groups.....	245

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 10 of 307

(v) Apportioning for Personal Income Tax Taxpayers .....	246
i. NOL Suspensions .....	248
j. S Corporations .....	248
k. Alternative Minimum Tax.....	248
l. Flow-through Losses .....	248
<b>CHAPTER 21 LOS ANGELES REVITALIZATION ZONE NET</b>	
<b>INTEREST DEDUCTION .....</b>	<b>249</b>
a. Introduction .....	249
b. Qualified Taxpayer .....	249
c. Qualified Debt.....	250
d. Net Interest Deduction – Computation .....	251
e. Expiration Of LARZ Designation.....	254
f. Record Keeping.....	254
<b>CHAPTER 22 PROGRAM AREA HIRING CREDIT .....</b>	<b>256</b>
a. Introduction .....	256
b. Qualified Business .....	256
c. Qualified Wages .....	257
d. Qualified Employee .....	258
e. Credit Computation.....	258
f. Wage Expense Deduction .....	260
g. Business Income Activity Limitation.....	260
h. General Provisions – Apportionment of Business Income .....	261
(i) Property Factor – Income Apportionment .....	261
(ii) Payroll Factor – Income Apportionment .....	262
(iii) Sales Factor – Income Apportionment .....	262
(iv) Apportionment – Combined Groups.....	263
(v) Apportioning for Personal Income Tax Taxpayers .....	263
i. S Corporations .....	265
j. Credit Usage & Carryover.....	265
k. Credit Will Not Reduce Certain Taxes .....	266
l. Credit Recapture .....	266
m. Record Keeping Requirements .....	267
<b>CHAPTER 23 PROGRAM AREAS SALES OR USE TAX CREDIT</b>	
.....	<b>269</b>
a. Introduction .....	269
b. "Taxpayer" Defined .....	269
c. Qualified Property .....	270
d. Credit Computation – Asset Value Limitation .....	270
e. Depreciable Basis .....	271
f. Business Income Activity Limitation.....	271
g. General Provisions - Income Apportionment .....	272
(i) Property Factor – Income Apportionment .....	273

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 11 of 308

(ii)	Payroll Factor – Income Apportionment .....	273
(iii)	Sales Factor – Income Apportionment .....	273
(iv)	Apportionment – Combined Groups .....	274
(v)	Apportioning for Personal Income Tax Taxpayers .....	275
h.	<b>S Corporation &amp; Shareholder Credit Amounts .....</b>	<b>276</b>
i.	<b>Sales or Use Tax Credit and the Hiring Credit .....</b>	<b>277</b>
j.	<b>Credit Usage and Carryover .....</b>	<b>277</b>
k.	<b>Credit Will Not Reduce Certain Taxes .....</b>	<b>278</b>
i.	<b>Depreciation .....</b>	<b>279</b>
m.	<b>Credit Recapture .....</b>	<b>279</b>
n.	<b>Record Keeping Requirements (Repealed Sections) .....</b>	<b>279</b>
<b>CHAPTER 24 PROGRAM AREA BUSINESS EXPENSE</b>		
<b>DEDUCTION .....</b>		<b>280</b>
a.	<b>Introduction .....</b>	<b>280</b>
b.	<b>Taxpayer Defined .....</b>	<b>280</b>
c.	<b>Qualified Property .....</b>	<b>281</b>
d.	<b>Property Not Qualified .....</b>	<b>281</b>
e.	<b>Deduction Amount .....</b>	<b>282</b>
f.	<b>Basis reduction .....</b>	<b>283</b>
g.	<b>Interaction with the Manufacturer's Investment Credit .....</b>	<b>283</b>
h.	<b>Election .....</b>	<b>283</b>
i.	<b>Depreciation .....</b>	<b>284</b>
j.	<b>Creating a Net Operating Loss .....</b>	<b>284</b>
k.	<b>Alternative Minimum Tax .....</b>	<b>284</b>
l.	<b>Recapture .....</b>	<b>284</b>
m.	<b>Checklist to Determine Eligibility for the Business Expense</b>	
	<b>Deduction .....</b>	<b>284</b>
n.	<b>Record Keeping Requirements .....</b>	<b>286</b>
<b>CHAPTER 25 PROGRAM AREA NET OPERATING LOSS .....</b>		<b>287</b>
a.	<b>Introduction .....</b>	<b>287</b>
b.	<b>Qualified Taxpayer .....</b>	<b>288</b>
c.	<b>Election .....</b>	<b>288</b>
d.	<b>Program Area NOL Computation - General Provisions .....</b>	<b>289</b>
e.	<b>Program Area NOL - Loss Attributed to Business Activity .....</b>	<b>289</b>
(i)	Property Factor – Loss Apportionment .....	290
(ii)	Payroll Factor – Loss Apportionment .....	290
(iii)	Sales Factor – Loss Apportionment .....	290
(iv)	Apportionment – Combined Groups .....	291
(v)	Apportioning for Personal Income Tax Taxpayers .....	292
f.	<b>Program Area NOL Limited by General NOL .....</b>	<b>293</b>
g.	<b>Carryover / Carryback .....</b>	<b>294</b>
h.	<b>General Provisions-NOL Carryover .....</b>	<b>295</b>

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 12 of 308

---

(i)	Program Area Income - Attributed to Business Activity .....	295
(ii)	Property Factor – Income Apportionment .....	296
(iii)	Payroll Factor – Income Apportionment .....	296
(iv)	Sales Factor – Income Apportionment .....	296
(v)	Apportionment – Combined Groups .....	297
(vi)	Apportioning for Personal Income Tax Taxpayers .....	298
i.	<b>NOL Suspensions</b> .....	<b>299</b>
j.	<b>S Corporations</b> .....	<b>299</b>
k.	<b>Alternative Minimum Tax</b> .....	<b>300</b>
l.	<b>Flow-through Losses</b> .....	<b>300</b>
<b>CHAPTER 26 PROGRAM AREA NET INTEREST DEDUCTION</b>		<b>301</b>
a.	<b>Introduction</b> .....	<b>301</b>
b.	<b>Qualified Taxpayer</b> .....	<b>301</b>
c.	<b>Qualified Debt</b> .....	<b>302</b>
d.	<b>Net Interest Deduction – Computation</b> .....	<b>303</b>
e.	<b>Repeal of Program Areas</b> .....	<b>306</b>
f.	<b>Record Keeping</b> .....	<b>306</b>

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## **CHAPTER 1 INTRODUCTION TO ECONOMIC DEVELOPMENT AREAS**

### **A. INTRODUCTION**

California currently has four types of Economic Development Areas (EDAs) that have related tax incentives. These areas are:

- Enterprise Zones (EZs);
- Local Agency Military Base Recovery Areas (LAMBRAs);
- Manufacturing Enhancement Areas (MEAs); and
- the Targeted Tax Area (TTA).

Taxpayers who conduct business activities within the boundaries of one of these areas or zones may qualify for special state tax incentives.

In prior years, special tax incentives were also available for taxpayers that conducted business activities within the boundaries of the former:

- Los Angeles Revitalization Zone (LARZ); and
- Program Areas.

The LARZ incentives applied to taxable or income years beginning on or after January 1, 1992, and before January 1, 1998.

The Program Area incentives applied to taxable or income years beginning on or after January 1, 1985, and before January 1, 1997. For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to EZs and are entitled to the benefits available to EZs.

#### ***Enterprise Zone Act / Employment and Economic Incentive Act***

The *Enterprise Zone Act* and the *Employment and Economic Incentive Act*, which became effective on March 20, 1984, established the mechanisms for designating economic development areas referred to as *Enterprise Zones* and *Program Areas* in California. Special tax incentives are available for entities and individuals that operate or invest in a business located within designated Enterprise Zones or Program Areas.

The law provides for the designation of 39 Enterprise Zones (per Government Code Section 7073). All 39 Enterprise Zones have been designated. See "*Enterprise Zone Locations and Designation Dates*" section (d).

## CALIFORNIA FRANCHISE TAX BOARD

EZ designations are effective for 15 years. An additional 5 year extension may be allowed if the EZ meets certain criteria. Extensions are approved by the California Trade & Commerce Agency, via an application process.

### ***Local Agency Military Base Recovery Area Act***

The Local Agency Military Base Recovery Area Act, which became effective on October 11, 1993, established the mechanisms for designating LAMBRAs to stimulate growth and development in areas that experience military base closures. A taxpayer that conducts a trade or business within a LAMBRA, and within the first two income or taxable years after commencing business has a net increase in jobs (defined as 2,000 paid hours per employee per year) of one or more employees in the LAMBRA, may qualify for special incentives.

The law provides for the designation of eight (8) LAMBRAs (per Government Code Section 7113.5). Tax incentives are not available until an area has received final designation from the California Trade & Commerce Agency. Designations are effective for eight years. See "*LAMBRA Locations and Designation Dates*" section (e).

### ***Enterprise Zone Act – Manufacturing Enhancement Area***

Effective January 1, 1998, the law provides for the designation of two (2) Manufacturing Enhancement Areas (per Government Code Section 7073.8). Both of the Manufacturing Enhancement Areas have been designated. A special tax incentive is available for entities and individuals that operate or invest in a business located within the designated Manufacturing Enhancement Areas.

Designations expire December 31, 2012. See "*MEA Locations and Designation Dates*" section (f).

### ***Targeted Tax Area – Government Code Section 7097***

The Targeted Tax Area was established to stimulate development in a selected economically depressed area. Special tax incentives are available for entities and individuals that operate or invest in a business located within the designated Targeted Tax Area.

The law provides for the designation of one (1) Targeted Tax Area (per Government Code Section 7097). The Targeted Tax Area designation expires October 31, 2013. See "*TTA Locations and Designation Date*" section (g).

## **B. EXPIRED ECONOMIC DEVELOPMENT AREAS**

The following expired EDAs were operative in prior years:

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## CALIFORNIA FRANCHISE TAX BOARD

- *Los Angeles Revitalization Zone (LARZ)*
- *Program Areas*

The LARZ was established in the areas of Los Angeles County that suffered from civil disturbances in April and May 1992. Taxpayers conducting business activities in this zone could qualify for special state tax incentives similar to the Enterprise Zone incentives. The LARZ became operative on May 1, 1992, and the tax incentives were applicable for taxable or income years beginning on or after January 1, 1992 and before January 1, 1998. The LARZ geographic area expired on December 1, 1998. See "*LARZ Locations and Designation Date*" section (h).

The first Program Areas were designated October 15, 1986. Program Area tax incentives were available for taxable or income year beginning before January 1, 1997. Taxpayers conducting business activities within a Program Area had to be certified by the California Trade & Commerce Agency as meeting specified work force standards to take advantage of the Program Area tax incentives. Program Areas were converted into EZs effective for taxable or income years beginning on or after January 1, 1997. All carryover credits and NOLs were converted into EZ carryovers and could be utilized in future years. The expiration dates of the Program Areas remained unchanged as a result of the conversion. See "*Program Area Locations and Designation Dates*" section (i).

### C. GEOGRAPHIC BOUNDARIES

A business may qualify for special tax incentives if it operates or invests in a trade or business located within the geographic boundaries of one of the EDAs. EDA geographic boundary information is available from:

**ENTERPRISE ZONE PROGRAMS  
CALIFORNIA TRADE AND COMMERCE AGENCY  
801 K STREET SUITE 1700  
SACRAMENTO CA 95814**

**Telephone:** (916) 324-8211

**FAX:** (916) 322-7214

**Internet Website:** [www.commerce.ca.gov](http://www.commerce.ca.gov)

### D. ENTERPRISE ZONE LOCATIONS AND DESIGNATION DATES

*Portions* of the following areas have been officially designated by the California Trade & Commerce Agency (TCA) as Enterprise Zones on the dates shown:

Location	Designatio	Expiration
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# CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 16 of 307

	n Date	Date
Altadena/Pasadena	04/10/92	04/09/2007
Antelope Valley	02/01/97	01/31/2012
Bakersfield/Kern (SE Bakersfield)*, *	10/15/86	10/14/2001*
Calexico *	10/15/86	10/14/2001*
Coachella Valley	11/11/91	11/10/2006
Delano	12/17/91	12/16/2006
Eureka*	10/15/86	10/14/2001*
Fresno*	10/15/86	10/14/2001*
Kings County	06/22/93	06/21/2008
Lindsey	10/06/95	10/05/2010
Long Beach	01/08/92	01/07/2007
Los Angeles-Central City *, *	10/15/86	10/14/2001*
Los Angeles-Eastside *, *	01/11/88	01/10/2003
Los Angeles-Harbor Area *, *	03/04/89	03/03/2004
Los Angeles-Mid Alameda Corridor *	10/15/86	10/14/2001*
Los Angeles-NE Valley (formerly Pacoima) *	10/15/86	10/14/2001*
Madera *, *	03/04/89	03/03/2004
Merced/Atwater	12/17/91	12/16/2006
Oakland	09/28/93	09/27/2008
Oroville	11/06/91	11/05/2006
Pittsburg *, *	01/11/88	01/10/2003
Porterville *	10/15/86	10/14/2001*
Redding/Anderson (Shasta Metro)	11/06/91	11/05/2006
Richmond	03/02/92	03/01/2007
Sacramento Army Depot	10/04/94	10/03/2009
Sacramento-Florin/Perkins *, *	04/05/89	04/04/2004
Sacramento-Northgate *, *	10/15/86	10/14/2001*
San Bernardino/Riverside (Agua Mansa) *	10/15/86	10/14/2001*
San Diego- Metropolitan (SE Barrio Logan) *	10/15/86	10/14/2001*
San Diego- San Ysidro/Otay Mesa	01/28/92	01/27/2007
San Francisco	05/28/92	05/27/2007
San Jose *	12/31/86	12/30/2001
Santa Ana	06/08/93	06/07/2008
Shafter	10/04/95	10/03/2010
Siskiyou County (Shasta Valley)	06/22/93	06/21/2008
Stockton	06/22/93	06/21/2008
Watsonville	05/01/97	04/30/2012
West Sacramento *, *	01/11/88	01/10/2003
Yuba/Sutter *	10/15/86	10/14/2001*

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## CALIFORNIA FRANCHISE TAX BOARD

***\*EZs eligible to file an application for a five year extension period of designation***

***\*Designated as Program Areas and converted to EZs effective for income or taxable years beginning on or after 1/1/97.***

### **E. LAMBRA LOCATIONS AND DESIGNATION DATES**

The law provides for the designation of eight (8) LAMBRAs (per Government Code Section 7113.5). There are currently six (6) LAMBRAs, designated on the dates shown:

Location	Designation Date	Expiration Date
Castle Airport Aviation & Development Center	06/01/1996	05/31/2004
Southern California Logistics Airport	02/01/1996	01/31/2004
Mare Island	01/01/1999	12/31/2006
San Bernardino International Airport & Trade Ctr.	04/01/2000	03/31/2008
Alameda Point	06/01/2000	05/31/2008
Mather Field & McClellan Park	07/01/2000	06/30/2008

One (1) other site has received conditional designation as a LAMBRA. This site is:

- Tustin Marine Corps Air Station in Tustin

**NOTE:** Tax incentives are not available until an area has received final designation from the California Trade & Commerce Agency.

### **F. MEA LOCATIONS AND DESIGNATION DATES**

The law provides for the designation of two (2) Manufacturing Enhancement Areas (per Government Code Section 7073.8). Both of the Manufacturing Enhancement Areas have been designated on the dates shown:

Location	Designation Date	Expiration Date
Brawley	10/01/98	12/31/2012
Calexico	10/01/98	12/31/2012

### **G. TTA LOCATIONS AND DESIGNATION DATE**

The law provides for the designation of one (1) Targeted Tax Area (per Government Code Section 7097).

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## CALIFORNIA FRANCHISE TAX BOARD

All of the incorporated cities in Tulare County and *portions* of the unincorporated areas of Tulare County received final designation as the TTA, effective November 1, 1998. The TTA expires December 31, 2012. The eight (8) incorporated cities in Tulare County are:

- Dinuba
- Exeter
- Farmersville
- Lindsay
- Porterville
- Tulare
- Visalia
- Woodlake

### H. LARZ LOCATIONS AND DESIGNATION DATES

The California Trade & Commerce Agency (formerly the Department of Commerce) officially designated *portions* of the following areas as the LARZ. The zone boundaries were designated 12/31/92 but were effective retroactively for qualified costs paid or incurred on or after 05/01/92 or 09/01/92. NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) by the Trade and Commerce Agency to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are still allowed to be utilized after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, generally, they are no longer available as of the first day of the income or taxable year beginning on or after the determination date (01/01/1996).

- Compton
- Hawthorne
- Huntington Park
- Inglewood
- Lawndale
- Long Beach
- Los Angeles
- Lynwood
- Pomona
- Signal Hill
- Unincorporated Los Angeles County

## CALIFORNIA FRANCHISE TAX BOARD

**NOTE:** The Los Angeles Revitalization Zone (LARZ) expired on December 1, 1998.

### I. PROGRAM AREA LOCATIONS AND DESIGNATION DATES

The California Trade & Commerce Agency officially designated *portions* of the following areas as Program Areas on the dates shown. Designations were effective for fifteen years.

Los Angeles-East Area	01/11/88
Los Angeles- Greater Watts	10/15/86
Los Angeles-Wilmington/San Pedro/Harbor	03/03/89
Madera	03/03/89
Pittsburg	01/11/88
Sacramento-Northgate	10/15/86
Sacramento-Oak Park/Florin-Perkins	04/05/89
S.E. Bakersfield	10/15/86
West Sacramento	01/11/88

**NOTE:** For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to EZs and are entitled to the benefits available to EZs.

### J. TAX INCENTIVES

The specific tax incentives available per EDA, and the relevant California Revenue & Taxation Code (CRTC) sections, include the following:

#### EZ

- Hiring Credit CRTC 17053.74 & 23622.7
- Sales or Use Tax Credit CRTC 17053.70 & 23612.2
- Business Expense Deduction CRTC 17267.2 & 24356.7
- Net Interest Deduction CRTC 17235 & 24384.5
- Net Operating Loss CRTC 17276.2 & 24416.2

#### LAMBRA

- Hiring Credit CRTC 17053.46 & 23646
- Sales or Use Tax Credit CRTC 17053.45 & 23645
- Business Expense Deduction CRTC 17268 & 24356.8
- Net Operating Loss CRTC 17276.5 & 24416.5

#### MEA

- Hiring Credit CRTC 17053.47 & 23622.8

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 20 of 307

### **TTA**

- Hiring Credit CRTC 17053.34 & 23634
- Sales or Use Tax Credit CRTC 17053.33 & 23633
- Business Expense Deduction CRTC 17267.6 & 24356.6
- Net Operating Loss CRTC 17276.6 & 24416.6

### **LARZ (REPEALED)**

- General Hiring Credit CRTC 17053.17 & 23623.5
- Construction Hiring Credit CRTC 17053.10 & 23625
- Sales or Use Tax Credit CRTC 17052.15 & 23612.6
- Business Expense Deduction CRTC 17266 & 24356.4
- Net Interest Deduction CRTC 17233 & 24385
- Net Operating Loss CRTC 17276.2 & 24416.2

## **K. REFERENCES**

### **Forms/Publications**

<a href="#">FTB1118</a>	Frequently Asked Questions About Local Agency Military Base Recovery Area (LAMBRA) Tax Incentives
<a href="#">FTB 1126</a>	Frequently Asked Questions About Enterprise Zone Tax Incentives
<a href="#">FTB 3553</a>	Enterprise Zone Employee Credit
<a href="#">FTB 3805Z</a>	Enterprise Zone Business Booklet
<a href="#">FTB 3806</a>	Los Angeles Revitalization Zone Business Booklet
<a href="#">FTB 3807</a>	Local Agency Military Base Recovery Area Business Booklet
<a href="#">FTB 3808</a>	Manufacturing Enhancement Area Business Booklet
<a href="#">FTB 3809</a>	Targeted Tax Area Business Booklet
<a href="#">FTB Pub. 1047</a>	Guidelines for Enterprise Zone Tax Incentives
<a href="#">FTB Pub. 1102</a>	Guidelines for Local Agency Military Base Recovery Area Tax Incentives
<a href="#">FTB Pub. 1145</a>	Guidelines for the Manufacturing Enhancement Area Tax Incentive
<a href="#">FTB Pub. 1157</a>	Guidelines for Targeted Tax Area Tax Incentives

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 21 of 307

---

**NOTE:** Program Area information can be found in the FTB 3805Z (Enterprise Zone and Program Area Business Booklet) for income and taxable years beginning prior to January 1, 1997.

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**CHAPTER 2 ENTERPRISE ZONE HIRING CREDIT****A. INTRODUCTION**

The California Revenue & Taxation Code (CRTC) provides a hiring credit for "qualified taxpayers" who employ "qualified employees" within a designated Enterprise Zone (EZ) and pay "qualified wages" to these employees. EZs were established in California to stimulate development in selected economically depressed areas.

The EZ hiring credit applies to those employees hired after the designation date of the EZ.

Prior to January 1, 1997, the applicable EZ hiring credit code sections were:

- 17053.8
- 23622

For taxable or income years beginning on or after January 1, 1997, the EZ hiring credit code sections are:

- 17053.74
- 23622.7

The following references in this chapter are to the new code section numbers. However, subdivision and paragraph numbering between the old and new code sections should parallel.

**Geographic Boundaries and Designation Dates**

For a listing of enterprise zones and designation dates, refer to Chapter 1, Section (d). For verifying an address, refer to Chapter 1, Section (c).

**B. QUALIFIED TAXPAYER****References 17053.74(b)(5); 23622.7(b)(5)**

A qualified taxpayer is:

- A person or entity that is engaged in a trade or business within an EZ, and
- Obtains and retains certification as discussed in Section (e) which provides that a qualified employee meets the eligibility requirements applicable

## CALIFORNIA FRANCHISE TAX BOARD

immediately preceding commencement of employment with the taxpayer as discussed in Section (d).

### Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The hiring credit is allowed to the pass-through entity and passed through to the partners or shareholders.

### Controlled Groups

#### References 17053.74(d)(1)(A); 23622.7(d)(1)(A); 23622.7(d)(1)(C)

All employees of trades or businesses that are under common control, or members of the same controlled group of corporations, shall be treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC 1563(a) as modified by the California Revenue & Taxation Code, to replace "*at least 80%*" with "*more than 50%*". The determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of IRC Section 1563.

**NOTE:** Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

### Acquired Businesses

#### References 17053.74(d)(2); 23622.7(d)(2)

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues to be employed in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues to be employed in that business.

**NOTE:** The new employer, "steps into the shoes" of the old employer for purposes of incurring future credits.

### C. QUALIFIED WAGES

#### References 17053.74(b)(1); 17053.74(b)(2); 17053.74(f); 23622.7(b)(1); 23622.7(b)(2)

*Qualified wages* are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer. For qualified employees hired before

## CALIFORNIA FRANCHISE TAX BOARD

the expiration date of the EZ, qualified wages paid or incurred within the 60-month period beginning with the first day the employee commences employment with the taxpayer shall continue to qualify for the credit after the zone expiration date, as if the EZ designation were still in existence and binding.

In general, *qualified wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- For taxable or income years beginning on or after January 1, 1996, for taxpayers engaged in aircraft manufacturing activities within the Long Beach Enterprise Zone, as described in the Standard Industrial Classification (SIC) Manual (1987 edition) Code sections 3721 through 3728, and 3812, qualified wages (for up to 1,350 qualified employees) means that portion of hourly wages that does not exceed 202% of the minimum wage.
- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

### ***Estates and Trust***

In the case of an estate or trust, the qualified wages shall be apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages have been apportioned, shall be treated as the employer with respect to those wages.

### ***Non-Qualified Wages***

Qualified wages *do not* include any wages paid or incurred on or after the zone expiration date except as noted previously for qualified employees hired prior to the expiration of the EZ.

### **Minimum Wage Chart**

EFFECTIVE DATE	MINIMUM WAGE	MAXIMUM HOURLY WAGE - HIRING CREDIT
July 1, 1988 to September 30, 1996	\$4.25	\$6.37 (150% of \$4.25)
October 1, 1996 to February 28, 1997	\$4.75	\$7.12 (150% of \$4.75)
March 1, 1997 to August 31, 1997	\$5.00	\$7.50 (150% of \$5.00)
September 1, 1997 to	\$5.15	\$7.72 (150% of \$5.15)

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## CALIFORNIA FRANCHISE TAX BOARD

February 28, 1998		
March 1, 1998 to Current	\$5.75	\$8.62 (150% of \$5.75)

### D. QUALIFIED EMPLOYEE

References 17053.74(b)(4)(A); 23622.7(b)(4)(A)

A *qualified employee* is an individual who satisfies all of the following:

#### **ANNUAL TESTS**

- At least 90% of the individual's work for the taxpayer, during the taxable or income year, must be directly related to the conduct of the taxpayer's trade or business located within an EZ;
- At least 50 % of the individual's services for the taxpayer, during the taxable or income year, must be performed within the boundaries of an EZ

#### **TIME OF HIRE TESTS**

- The individual is hired after the area was designated as an EZ; and
- Immediately prior to commencement of employment with the taxpayer, the individual is any of the following:

#### ***For taxable or income years beginning on or after January 1, 1997:***

1. Eligible for services under the federal Job Training Partnership Act (JTPA), or its successor;
2. Eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor;
3. An economically disadvantaged individual 14 years of age or older;
4. A qualified dislocated worker (refer to the CRTC or the 3805Z Business Booklet for an expanded definition);
5. A disabled individual who is eligible for, enrolled in, or who has completed a state rehabilitation plan;
6. A service-connected disabled veteran;
7. A veteran of the Vietnam era;
8. A veteran who recently separated from military service;
9. An ex-offender;
10. A person eligible for, or a recipient of any of the following:
  - Federal Supplemental Security Income (SSI) benefits;
  - Aid to Families with Dependent Children (AFDC);
  - Food stamps; or
  - State and local general assistance.
11. A Native American;
12. A resident of a Targeted Employment Area (TEA), as defined in Section 7072 of the Government Code;

## CALIFORNIA FRANCHISE TAX BOARD

13. An employee who qualified the taxpayer for the Enterprise Zone hiring credit under former CRTC Sections 17053.8 & 23622;
14. An employee who qualified the taxpayer for the Program Area hiring credit under former CRTC Sections 17053.11 & 23623; or
15. A member of a targeted group, as defined in IRC Section 51(d), or its successor.

### **For taxable or income years beginning on or after January 1, 1995 and before January 1, 1997**

1. Eligible for services under the federal Job Training Partnership Act (JTPA), or its successor;
2. Eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor;
3. Eligible, as determined by EDD, under the federal Targeted Jobs Tax Credit Program, as long as that program is in effect

### **For taxable or income years beginning before January 1, 1995**

1. Receiving services under the federal Job Training Partnership Act (JTPA), or its successor;
2. Eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor;
3. Eligible as certified by EDD, under the federal Targeted Jobs Tax Credit Program, as long as that program is in effect

### **Seasonal Employees**

**References 17053.74(b)(1)(B); 17053.74(b)(6); 23622.7(b)(1)(B); 23622.7(b)(6)**

"Seasonal employment" means employment that has regular and predictable substantial reductions in business operations.

Reemployment of an individual, in connection with any increase (including a regularly occurring seasonal increase) in business operations, does not constitute commencement of employment for purposes of the EZ hiring credit.

### **Leased Employees**

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer can be identified due to the legal obligation to pay the payroll taxes of the employee, and as to who has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, *Employer's Supplemental Tax Guide* provides guidelines for establishing an employment relationship and

## CALIFORNIA FRANCHISE TAX BOARD

provides examples to consider in determining the employer-employee relationship.

### **E. VOUCHERING FORM TCA EZ1**

**References 17053.74(c); 23622.7(c)**

The *Form TCA EZ1* is the certification, which provides that the qualified employee meets the eligibility requirements of a qualified employee as discussed in Section (d). The qualified taxpayer shall get *Form TCA EZ1* from one of the following applicable entities:

- The Employment Development Department (EDD);
- The local county JTPA administrative entity;
- The local city JTPA administrative entity;
- The local county GAIN office; or
- The social services agency.

The EDD may provide preliminary screening and referral to the certifying agency. The qualified taxpayer needs to retain a copy of the certification and provide it upon request to the Franchise Tax Board.

### **F. CREDIT COMPUTATION**

**References 17053.74(a); 23622.7(a)**

For each income or taxable year a hiring credit shall be allowed to a qualified taxpayer for hiring a qualified employee for employment within an EZ. The credit shall be equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit will be used.

**Example:** An employee was hired 7/1/1998, and the taxpayer is completing the tax return for the year ending 12/31/1999. For the period

## CALIFORNIA FRANCHISE TAX BOARD

1/1/1999 to 6/30/1999, the hiring credit is based on 50% of qualified wages. For the period 7/1/1999 to 12/31/1999, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

**Example:** An employee is hired 7/1/1998, is temporarily laid off 2/1/1999, and is rehired 4/1/1999. The 50% credit range runs from 7/1/1998 to 6/30/1999 regardless of the layoff period between 2/1/1999 and 3/31/1999.

### G. REDUCTION FOR OTHER TAX CREDITS

**References 17053.74(h); 23622.7(h)**

The EZ hiring credit shall be reduced by the credits allowed under the following sections *for the same employee*:

- CRTC 17053.10 & 23625 (LARZ construction hiring credit);
- CRTC 17053.17 & 23623.5 (LARZ general hiring credit);
- CRTC 17053.46 & 23646 (LAMBRA hiring credit); and
- The federal credit allowed under IRC Section 51 (Work Opportunity Tax Credit – WOTC).

### H. WAGE EXPENSE REDUCTION

**References 17053.74(h); 23622.7(h)**

The taxpayer must reduce any deduction for wages by the amount of the EZ hiring credit allowed (includes any current year credit to be carried forward).

### I. BUSINESS INCOME ACTIVITY LIMITATION

**References 17053.74(j); 23622.7(j)**

The amount of the hiring credit or the sales or use tax credit (see Chapter 3) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's EZ business income in any year. Depending on the tax year involved, the EZ business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the EZ. Non-business income or loss is not included in the calculation of business income from the EZ. Each taxpayer claiming the credit must compute the EZ business income and resulting tax.

## CALIFORNIA FRANCHISE TAX BOARD

**Example:** Corp. A operates entirely within an EZ. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	2,000
Business expenses	<u>(17,000)</u>
<b>Net taxable income before taxes</b>	<b>\$15,000</b>

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	<u>(17,000)</u>
<b>Net Business Income</b>	<b>\$13,000</b>

To determine the EZ hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	\$13,000
x 8.84%	<u>x .0884</u>
Tax associated with business income	\$1,149

In this example, the taxpayer can offset the tax of \$1,149 with the hiring credit available (up to \$1,149).

**NOTE:** "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

### **J. GENERAL PROVISIONS – APPORTIONMENT OF BUSINESS INCOME** **References 17053.74(j)(2)&(3); 23622.7(j)(2)&(3)**

If a business is located within and outside of an EZ, or in more than one zone, the taxpayer must determine the portion of the business income that is attributable to each EZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

## CALIFORNIA FRANCHISE TAX BOARD

For income or taxable years beginning on or after January 1, 1998, business income shall be apportioned to the EZ by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning after January 1, 1996 and before January 1, 1998 (1996 fiscal year taxpayers, 1997 year taxpayers), business income is apportioned to the EZ by use of a four-factor apportionment formula. Worldwide business income is multiplied by a fraction, the numerator of which is the property factor, payroll factor, and the double-weighted sales factor. The denominator is four (4).

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991- 1995 year taxpayers and 1996 calendar year taxpayers), business income is apportioned to the EZ by multiplying the worldwide business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning before January 1, 1991, income or loss attributed to an EZ is determined by multiplying worldwide business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

### (i) **Property Factor – Income Apportionment**

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the EZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.
- For income or taxable years beginning before January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

## CALIFORNIA FRANCHISE TAX BOARD

### (ii) Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the EZ during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1998, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.
- For income or taxable years beginning before January 1, 1998, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

### (iii) Sales Factor – Income Apportionment

The sales factor is a fraction.

- The numerator of the sales factor is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayer's trade or business in the EZ.
- The denominator is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

**Example** - Two-factor apportionment: For the income year ending 12/31/99, Corp. A operates within and outside an EZ. California business income of \$13,000 needs to be apportioned to the EZ. The following amounts apply to Corp. A's property and payroll:

EZ Property	\$40,000
CA Property	\$100,000
EZ Payroll	\$5,000
CA Payroll	\$10,000

EZ Property/CA Property	= .40	
EZ Payroll/CA Payroll	= <u>.50</u>	
	.90/2 = .45	EZ Apportionment Factor

Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
EZ Business Income	\$5,850

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## CALIFORNIA FRANCHISE TAX BOARD

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Current Tax Rate	$\times .0884$
Tax attributable to EZ business income	\$517

**NOTE:** The four-factor apportionment formula is as follows:

Zone income = (property, payroll, & sales factors/ 4) x worldwide business income.

Property factor = zone property/worldwide property

Payroll factor = zone payroll/worldwide payroll

Sales Factor = zone sales/worldwide sales x 2

### (iv) Apportionment – Combined Groups

For income or taxable years beginning before January 1, 1998: For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each enterprise zone taxpayer's separate enterprise zone payroll and property amounts (and sales as discussed in Section (h)), and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in Section (h)).

For an example of apportionment under this method refer to Chapter 23, Section (g)(iv).

For income or taxable years beginning on or after 1/1/1998: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the enterprise zone. The numerator of the apportionment formula will be based on each enterprise zone taxpayer's separate enterprise zone property and payroll amounts and the denominator will be based on each enterprise zone taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the EZ. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate EZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the EZ was determined as follows:

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**CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 33 of 307

	A	B
<u>Property Factor</u>		
EZ Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
EZ Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
<i>Average Apport. %</i>	<i>100%</i>	<i>73.33%</i>
<i>(Property + Payroll Factors)/2</i>		
<i>Apportioned Business Income</i>	<i>\$228,000</i>	<i>\$250,000</i>
<i>EZ Income</i>	<i>\$228,000</i>	<i>\$183,333</i>

**(v) Apportioning for Personal Income Tax Taxpayers**

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an EZ and one outside the EZ. Eighty percent (80%) of the S corporation's business is attributable to the EZ. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the EZ.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	

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## CALIFORNIA FRANCHISE TAX BOARD

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Ordinary income	40,000
EZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The EZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's EZ income is computed as follows:

Ray's EZ salary (\$100,000 x 50%)	\$50,000
Mary's EZ salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. (\$40,000 x 80%)	32,000
EZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	<u>(1,000)</u>
Total EZ income	\$151,000

Ray and Mary must compute the tax on the total EZ income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status married filing joint; the 1999 tax on \$151,000 is \$10,659. The \$10,659 is the first limitation on EZ credits for the 1999 tax year. The second limitation on the credits is the net tax on all income.

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of EZ income since they are not related to trade or business activities.

### K. S CORPORATIONS

**References 23803(a)(1)(A); 23803(a)(1)(F)**

An S corporation's hiring credit may reduce the EZ tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's EZ income.

One hundred percent (100%) of the EZ credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

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## CALIFORNIA FRANCHISE TAX BOARD

**Example:** An S corporation computes a \$3,000 hiring credit. The S corporation's credit is \$1,000 and the wage reduction is \$1,000. The \$3,000 credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is \$3,000.

### L. CREDIT USAGE & CARRYOVER

**References 17039(d); 17053.74(i); 17053.74(j)(1); 17053.74(j)(4); 23036(f); 23622.7(i); 23622.7(j)(1); 23622.7(j)(4)**

The total amount of the EZ hiring credit and sales or use tax credit, including any credit carryover from prior years, that may reduce the "tax"/"net tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the EZ, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the "tax"/"net tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

If a credit carryover remains after the EZ has expired, is no longer binding, or becomes inoperative, the EZ shall be deemed to remain in existence for purposes of computing the taxpayer's business income attributable to the EZ.

**Example:** A taxpayer has a \$4,900 EZ hiring credit. Tax imposed on EZ business income is \$4,700 and the taxpayer's overall "net tax"/"tax" is \$4,000. The taxpayer would be eligible to claim a \$4,000 maximum hiring credit.

Total hiring credit	\$4,900
Tax on EZ income	\$4,700
<b><u>First limitation:</u></b>	
Lesser of total credit or tax on EZ income	\$4,700
<b><u>Second limitation:</u></b>	
Lesser of tax on EZ income or "net tax"/"tax"	\$4,000
<b><u>Maximum credit allowed:</u></b>	
Lesser of EZ tax limitation or "net tax"/"tax" limitation	<u>\$4,000</u>
Total hiring credit	\$4,900
Maximum credit allowed	<u>\$4,000</u>
Carryover	\$ 900

**M. CREDIT WILL NOT REDUCE CERTAIN TAXES**

The EZ hiring credit *cannot* reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation); or
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries).

The EZ hiring credit can reduce the regular tax below tentative minimum tax (TMT) for taxable or income years beginning on or after January 1, 1993.

**N. CREDIT RECAPTURE**

***References 17053.74(e)(1); 17053.74(e)(3); 23622.7(e)(1); 23622.7(e)(3)***

***Non-Seasonal Employees***

Except as discussed subsequently, recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods:

- The first 270 "days of employment" (whether or not consecutive); or
- Ninety (90) "days of employment" plus 270 calendar days.

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

***Seasonal Employees***

For income or taxable years beginning on or after January 1, 1998, for seasonal employees, the taxpayer must recapture the amount of the credit if employment is terminated before the completion of 270 "days of employment" during the 60-month period beginning the day the employee commences employment with the taxpayer except as subsequently discussed.

To recapture the credit, the taxpayer must add the amount of credit previously claimed in all years to the tax for the tax year that includes the 60<sup>th</sup> month of employment.

For all employees, a "day of employment" includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

**NOTE:** Any increase in tax, due to credit recapture, cannot be offset by the current year hiring credit.

***Credit Recapture – Exceptions***

**References 17053.74(e)(2)(A); 17053.74(e)(2)(B); 23622.7(e)(2)(A); 23622.7(e)(2)(B)**

For both regular and seasonal employees, the credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business; or
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

***Change in the Form of the Trade or Business***

**References 17053.74(e)(2)(C); 23622.7(e)(2)(C)**

The employment relationship between the taxpayer and an employee shall not be treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues to be employed in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee shall not be treated as terminated. In addition, transactions in which IRC Section 381(a) applies will not trigger recapture if the employee continues to be employed by the acquiring corporation.

**O. RECORD KEEPING REQUIREMENTS**

For each qualified employee, documentation showing:

- Voucher
- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

## **CHAPTER 3 ENTERPRISE ZONE SALES OR USE TAX CREDIT**

### **A. INTRODUCTION**

***References 17053.70(a); 17053.70(b); 23612.2(a); 23612.2(b)***

A taxpayer engaged in a trade or business within a designated Enterprise Zone (EZ) can take a credit for sales or use tax paid or incurred in connection with the purchase of qualified property.

- In any year, individuals may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first \$1 million of qualified property.
- In any year, corporations may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first \$20 million of qualified property. (See special rule for S corporations and shareholders in Section (i)).

No credit may be claimed for property purchased after the EZ designation expires, is no longer binding, or becomes inoperative.

Prior to January 1, 1997, the applicable EZ sales or use tax credit code sections were:

- 17052.13
- 23612

For taxable or income years beginning on or after January 1, 1997, the EZ sales or use tax credit code sections are:

- 17053.70
- 23612.2

The following references in this chapter are to the new code section numbers. However, subdivision and paragraph numbering between the old and new code sections should parallel.

### ***Geographic Boundaries and Designation Dates***

For a listing of enterprise zones and designation dates, refer to Chapter 1, Section (d). For verifying an address, refer to Chapter 1, Section (c).

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 39 of 307

### **B. MULTIPLE CREDITS ALLOWED**

Property which qualifies for the EZ sales or use tax credit may also qualify for the Manufacturers' Investment Credit. The taxpayer is allow to take both credits on the same property. The EZ sales or use tax credit must be computed first, basis reduced, and then the Manufacturers' investment Credit computed on the remaining basis.

### **C. QUALIFIED TAXPAYER**

**References 17053.70(b)(1); 23612.2(b)(1)**

A qualified taxpayer is a person or entity that is engaged in a trade or business within an EZ.

#### ***Pass-Through Entities***

The determination of whether a taxpayer is a *qualified taxpayer* is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The sales or use tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

### **D. QUALIFIED PROPERTY**

**References 17053.70(b)(2); 23612.2(b)(2)**

Qualified property must be used exclusively in the EZ and is defined as machinery and machinery parts used for:

- fabricating, processing, assembling, and manufacturing;
- the production of renewable energy resources;
- air pollution control mechanisms; and
- water pollution control mechanisms.

For income or taxable years beginning on or after January 1, 1998, qualified property also includes:

- data processing and communications equipment, such as computers, computer-automated drafting systems, copy machines, telephone systems, and fax machines; or
- motion picture manufacturing equipment central to production and post-production, such as cameras, audio recorders, and digital image and sound processing equipment.

Generally, qualified machinery parts include those parts that are necessary for the operation of the machinery (e.g., a conveyor belt).

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## CALIFORNIA FRANCHISE TAX BOARD

Excluded parts are those used to complete a certain job. They are typically expensed to cost of goods sold or general expense accounts (e.g., specialized drill blades and oil utilized for routine maintenance work).

### ***Leased Property***

Taxpayers who acquire property by lease arrangement may qualify for the sales or use tax credit. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the sales or use tax credit. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

### **E. CREDIT COMPUTATION – ASSET VALUE LIMITATION**

***References 17053.70(a); 17053.70(b)(2); 23612.2(a); 23612.2(b)(2)***

The sales or use tax credit is equal to the amount of sales or use tax “paid or incurred” by the taxpayer in connection with the purchase and use of qualified property.

***Example:*** Taxpayer spent \$53,750 to purchase property used in the taxpayer's business within the EZ. The sales tax paid on the purchase is \$3,750. The sales tax credit is \$3,750.

Individuals, estates or trusts, partnerships, and limited liability companies (LLCs) taxed as partnerships may claim a credit on the sales or use tax paid or incurred to purchase up to \$1 million of qualified property. Corporations may claim a credit on the sales or use tax paid or incurred to purchase up to \$20 million of qualified property. This limitation applies to each income or taxable year. (See special rule for S corporations and shareholders in Section (i)).

**NOTE:** Upon acquisition, if the taxpayer/purchaser was exempt from paying sales tax on the property under the California Revenue & Taxation Code (CRTC), then the taxpayer/purchaser did not pay or incur sales tax in connection with the purchase of the property to the extent of the exemption. Thus, the taxpayer/purchaser is not allowed to take the sales or use tax credit on the amount of the exemption.

### ***Use Tax Paid on Qualified Property***

***References 17053.70(c) 23612.2(c)***

If a taxpayer, operating within an EZ, purchases property out of state and pays or incurs a use tax, the credit will be allowed only if qualified property of a comparable quality and price is not timely available for purchase in this state.



## CALIFORNIA FRANCHISE TAX BOARD

### F. DEPRECIABLE BASIS

**References** 17053.70(e); 23612.2(e)

Any taxpayer that elects to claim the sales or use tax credit, shall not increase the basis of the qualified property by the amount of the sales or use tax paid or incurred.

**Example:** Taxpayer spent \$53,750 to purchase property used in the taxpayer's business within the EZ. The sales tax included in the purchase price was \$3,750. The basis of the property is \$50,000 (\$53,750 less \$3,750 sales tax).

### G. BUSINESS INCOME ACTIVITY LIMITATION

**References** 17053.70(f); 23612.2(f)

The amount of sales or use tax credit and the hiring credit (see Chapter 2) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's EZ business income in any year. Depending on the tax year involved, the EZ business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the EZ. Non-business income or loss is not included in the calculation of business income from the EZ. Each taxpayer claiming the credit must compute the EZ business income and resulting tax.

**Example:** Corp. A operates exclusively within an EZ. In order to determine the amount of sales or use tax credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	\$2,000
Business expenses	<u>(17,000)</u>
Net Taxable Income	\$15,000

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	<u>(17,000)</u>
Net Business Income	\$13,000

To determine the sales or use tax credit allowable, the net business income is multiplied by the current tax rate.

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## CALIFORNIA FRANCHISE TAX BOARD

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Net Business Income	\$13,000
x 8.84%	<u>x .0884</u>
Tax associated with business income	\$1,149

In this example, the taxpayer can offset the tax of \$1,149 with the sales or use tax credit available (up to \$1,149).

**NOTE:** "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

### **H. GENERAL PROVISIONS – APPORTIONMENT OF BUSINESS INCOME** ***References 17053.70(f); 23612.2(f)***

If a business is located within and outside of an EZ, or in more than one zone, the taxpayer must determine the portion of the total business income that is attributable to each EZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1998, business income shall be apportioned to the EZ by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning after January 1, 1996 and before January 1, 1998 (1996 fiscal year taxpayers, 1997 year taxpayers), business income is apportioned to the EZ by use of a four-factor apportionment formula. Worldwide business income is multiplied by a fraction, the numerator of which is the property factor, payroll factor, and the double-weighted sales factor. The denominator is four (4).

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991- 1995 year taxpayers and 1996 calendar year taxpayers), business income is apportioned to the EZ by multiplying the worldwide business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning before January 1, 1991, income or loss attributed to an EZ is determined by multiplying worldwide business income or

loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

**(i) Property Factor – Income Apportionment**

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the EZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.
- For income or taxable years beginning before January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

**(ii) Payroll Factor – Income Apportionment**

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the EZ during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1998, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.
- For income or taxable years beginning before January 1, 1998, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

**(iii) Sales Factor – Income Apportionment**

The sales factor is a fraction.

- The numerator of the sales factor is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayer's trade or business in the EZ.

## CALIFORNIA FRANCHISE TAX BOARD

- The denominator is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

**Example** - Two-factor apportionment: For the income year ending 12/31/99, Corp. A operates within and outside an EZ. California business income of \$13,000 needs to be apportioned to the EZ. The following amounts apply to Corp. A's property and payroll:

EZ Property	\$40,000
CA Property	\$100,000
EZ Payroll	\$5,000
CA Payroll	\$10,000

EZ Property/CA Property	= .40	
EZ Payroll/CA Payroll	= <u>.50</u>	
	.90/2 = .45	EZ Apportionment Factor

Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
EZ Business Income	\$5,850
Current Tax Rate	<u>x .0884</u>
Tax attributable to EZ business income	\$517

**NOTE:** The four-factor apportionment formula is as follows:

Zone income = (property, payroll, & sales factors/ 4) x worldwide business income.

Property factor = zone property/worldwide property

Payroll factor = zone payroll/worldwide payroll

Sales Factor = zone sales/worldwide sales x 2

### (iv) Apportionment – Combined Groups

For income or taxable years beginning before January 1, 1998: For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each enterprise zone taxpayer's separate enterprise zone payroll and property amounts (and sales as discussed

## CALIFORNIA FRANCHISE TAX BOARD

in Section (h)), and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in Section (h)).

For an example of apportionment under this method refer to Chapter 23, Section (g)(iv).

For income or taxable years beginning on or after 1/1/1998: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the enterprise zone. The numerator of the apportionment formula will be based on each enterprise zone taxpayer's separate enterprise zone property and payroll amounts and the denominator will be based on each enterprise zone taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the EZ. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate EZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the EZ was determined as follows:

	A	B
<u>Property Factor</u>		
EZ Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
EZ Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
Average Apport. %	100%	73.33%
(Property + Payroll Factors)/2		
Apportioned Business Income	\$228,000	\$250,000

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

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EZ Income	\$228,000	\$183,333
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### (v) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an EZ and one outside the EZ. Eighty percent (80%) of the S corporation's business is attributable to the EZ. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the EZ.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
EZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The EZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's EZ income is computed as follows:

Ray's EZ salary (\$100,000 x 50%)	\$50,000
Mary's EZ salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp.	
(\$40,000 x 80%)	32,000
EZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	<u>(1,000)</u>
Total EZ income	\$151,000

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## CALIFORNIA FRANCHISE TAX BOARD

Ray and Mary must compute the tax on the total EZ income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status married filing joint; the 1999 tax on \$151,000 is \$10,659. The \$10,659 is the first limitation on EZ credits for the 1999 tax year. The second limitation on the credits is the net tax on all income.

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of EZ income since they are not related to trade or business activities.

### I. S CORPORATION & SHAREHOLDER CREDIT AMOUNTS

**References** 17053.70(b)(2)(B); 23612.2(b)(2)(B); 23803

S corporations operating within a EZ may claim a credit on the sales or use tax paid or incurred to purchase up to \$20 million of qualified property. This limitation applies to each income year. The S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's EZ income.

An S corporation's sales or use tax credit may reduce the EZ tax at both the corporate and shareholder levels. One hundred percent (100%) of the EZ credits are passed through to the S corporation shareholders. However, S corporation shareholders are only allowed to claim a credit on the sales or use tax paid or incurred on the purchase of up to \$1 million of qualified property of the S corporation for each taxable year. The shareholders claim their pro-rata share of this credit as recomputed under the California personal income tax law (Part 10).

The sales or use tax credit is first computed for the S corporation using the actual qualified acquisition costs not to exceed \$20 million. The amount of credit passing through to the shareholders is then computed using the actual qualified acquisition costs not to exceed \$1 million. This credit based on the \$1 million limitation is passed through to the shareholders based on their pro rata share. The Schedules K (100S) and K-1 (100S) must state the credit amounts allocable to the shareholders.

**Example:** Corp. Z, an S corporation, purchases \$2 million of qualified property, and takes the EZ sales or use tax credit. Corp. Z is allowed to claim a sales or use tax credit of \$50,000 ( $\$2,000,000 \times 7.5\% \times 1/3 = \$50,000$ ). [Cost (not to exceed \$20,000,000) x sales tax rate x 1/3 S corporation credit limitation]

The corporation's two shareholders allocate between them a sales or use tax credit of \$75,000 ( $\$1,000,000 \times 7.5\% = \$75,000$ ). [Cost (not to exceed \$1,000,000) x sales tax rate]

## CALIFORNIA FRANCHISE TAX BOARD

### J. SALES OR USE TAX CREDIT AND THE HIRING CREDIT

**References 17053.70(f)(1); 23612.2(f)(1)**

The amount of credit(s) allowed, in any income or taxable year, when a taxpayer is eligible to take both the sales or use tax credit and the hiring credit, is limited to the amount of tax imposed on the EZ income. Thus, the taxpayer must aggregate the credits and limit the total amount of credits to tax imposed on the EZ income.

### K. CREDIT USAGE AND CARRYOVER

**References 17053.70(d); 17053.70(f); 23612.2(d); 23612.2(f)**

The portion of the credit that exceeds the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

The aggregate amount of EZ credits, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the EZ, determined as if that income represented all of the income of the taxpayer.

**Example:** A taxpayer has \$4,900 in EZ credits (sales or use tax credit and hiring credit). Tax imposed on EZ business income is \$4,700 and the taxpayer's overall "net tax"/"tax" is \$4,000. The maximum amount of credit is limited to the lesser of the tax on the EZ business income, or the tax on the taxpayer's overall "net tax"/"tax".

Total EZ credit	\$4,900
Tax on EZ income	\$4,700
<b><u>First limitation:</u></b>	
Lesser of total credit or tax on EZ income	\$4,700
<b><u>Second limitation:</u></b>	
Lesser of tax on EZ income or "net tax"/"tax"	\$4,000
Maximum credit allowed:	
Lesser of EZ tax limitation or "net tax"/"tax" limitation	<u>\$4,000</u>
 Total EZ credit	 \$4,900
Maximum credit allowed	<u>\$4,000</u>
Carryover	\$ 900

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In the event that a credit carryover is allowable for any income or taxable year after the EZ designation has expired; the EZ will be deemed to remain in existence for the purpose of computing the business income limitation.

**L. CREDIT WILL NOT REDUCE CERTAIN TAXES**

The EZ sales or use tax credit cannot reduce the:

- minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- built-in gains tax (S corporations);
- excess net passive income tax (S corporation); or
- alternative minimum tax (corporations, exempt organizations, individuals, and fiduciaries).

The EZ sales or use tax credit may however reduce regular tax below tentative minimum tax for income and taxable years beginning in 1993 and later.

**M. DEPRECIATION**

**References 17053.70(e); 17267.2(f); 18036; 23612.2(e); 24356.7(e); 24916**

Taxpayers electing to utilize the sales or use tax credit are not entitled to increase the basis of the property for which sales or use tax was paid or incurred in connection with the purchase of the property.

Depreciation of the capitalized cost of the asset may be claimed using any method of depreciation allowable beginning in the year the asset is placed in service.

**NOTE:** After December 31, 1996, if the business expense deduction is taken for the same property, depreciation will start with the income or taxable year following the year in which the property is placed in service. The depreciation is calculated on the remaining basis after reduction for the sales or use tax credit and business expense deduction amounts.

**N. CREDIT RECAPTURE**

There are no recapture provisions for the EZ sales or use tax credit.

**O. RECORD KEEPING REQUIREMENTS**

To support the sales or use tax credit claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items

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## **CALIFORNIA FRANCHISE TAX BOARD**

such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- the property purchased (such as serial numbers, etc.);
- the amount of sales or use tax paid or incurred upon purchase;
- the location where the property is used; and
- if purchased from a manufacturer located outside California, records to substantiate that property of comparable quality and price was not available for purchase in California.

## **CHAPTER 4 ENTERPRISE ZONE BUSINESS EXPENSE DEDUCTION**

### **A. INTRODUCTION**

***References 17267.2(a); 24356.7(a)***

For each income or taxable year, a taxpayer engaged in a trade or business within an Enterprise Zone (EZ), may elect to treat 40% of the eligible cost of qualified property as a business expense rather than a capital expense.

The deduction shall be allowed for the income or taxable year in which the property is placed in service.

Prior to January 1, 1997, the applicable EZ business expense deduction code sections were:

- 17252.5
- 24356.2

For taxable or income years beginning on or after January 1, 1997, the EZ business expense deduction code sections are:

- 17267.2
- 24356.7

The following references in this chapter are to the new code section numbers. However, subdivision and paragraph numbering between the old and new code sections should parallel.

#### ***Geographic Boundaries***

For a listing of enterprise zones and designation dates, refer to Chapter 1, Section (d). For verifying an address, refer to Chapter 1, Section (c).

### **B. QUALIFIED TAXPAYER**

***References 17267.2(e); 24356.7(d)***

A qualified taxpayer is a person or entity that conducts a trade or business within an EZ.

#### ***Estates and Trusts***

***References 17267.2(d)(4)***

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Estates and trusts are not allowed to take the business expense deduction.

***Pass-Through Entities***

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

**C. QUALIFIED PROPERTY*****References 17267.2(d)(1); 24356.7(c)(1)***

Qualified property is IRC Section 1245 property (as defined in section 1245(a)(3) of the Internal Revenue Code) purchased and placed in service for *exclusive use* in a trade or business conducted within an EZ. The property must also be purchased and placed in service *before* the date the EZ designation expires, is no longer binding, or becomes inoperative.

Qualified property under IRC Section 1245 includes, but is not limited to, tangible personal property (excluding buildings and inventory) that is subject to the allowance for depreciation. This includes most equipment and furnishings purchased for *exclusive use* within the EZ. Office supplies and other small non-depreciable items are not included.

***Leased Property***

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994

**D. PROPERTY NOT QUALIFIED*****References 17267.2(d); 24356.7(c)***

The business expense deduction will not be allowed if the property:

- was transferred between members of an affiliated group;
- was acquired as a gift or inherited;
- was traded for other property;
- was received from a personal or business relation as defined by IRC Section 267, as modified by 17267.2(d)(2)(A);

## CALIFORNIA FRANCHISE TAX BOARD

- was received from a personal or business relation as defined by California Revenue & Taxation Code Sections 24427 through 24429, as modified by 24356.7(c)(2)(A);
- was received from a personal or business relation as defined by IRC Section 707(b); or
- is described in IRC Section 168(f).

### E. DEDUCTION AMOUNT

**References 17267.2(g); 24356.7(f)**

For income or taxable years beginning before January 1, 1997, the maximum *deduction* the taxpayer may claim in any income or taxable year is determined by the number of years that have elapsed since the zone was designated, as follows:

Income or Taxable Years	Maximum Deduction
Income or taxable year of designation and 1 <sup>st</sup> year thereafter	\$5,000
2 <sup>nd</sup> and 3 <sup>rd</sup> income or taxable year thereafter	\$ 7,500
Each income or taxable year thereafter	\$10,000

For income or taxable years beginning on or after January 1, 1997, the maximum *deduction* the taxpayer may claim in any income or taxable year is determined by the number of years that have elapsed since the zone was designated, as follows:

Income or Taxable Years	Maximum Aggregate Cost	Maximum Deduction
Income or taxable year of designation and 1 <sup>st</sup> year thereafter	\$100,000	\$40,000
2 <sup>nd</sup> and 3 <sup>rd</sup> income or taxable year thereafter	\$75,000	\$30,000
Each income or taxable year thereafter	\$50,000	\$20,000

\*For those businesses located in the expansion area of an EZ, the amount of the deduction is determined by using the original designation date of the EZ.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 54 of 307

### ***Partnerships***

#### ***References 17267.2(d)(6)***

In the case of a partnership, the percentage limitation (40%) of the aggregate cost of all qualified property shall apply at the partnership level and at the partner level.

### ***Personal Income Tax Taxpayers-Married Filing Separate***

#### ***References 17267.2(b)***

In the case of a husband and wife filing separate returns for a taxable year, the applicable deduction shall be equal to one-half (50%) of the otherwise allowable deduction.

## **F. BASIS REDUCTION**

The basis of the asset is to be reduced by the amount of the expense deduction claimed.

## **G. INTERACTION WITH THE MANUFACTURERS' INVESTMENT CREDIT**

#### ***References 17053.49(b)(1)(C); 23649(b)(1)(C)***

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

## **H. ELECTION**

#### ***References 17267.2(a); 17267.2(c); 24356.7(a); 24356.7(b)***

The taxpayer must make an election to treat the cost of qualified property as a business expense, on the original return filed for the income or taxable year the property is first placed in service. The election must specify the items to which the election applies and the portion of the cost taken into account for purposes of determining the deduction amount.

The election may not be revoked, unless the taxpayer has obtained the consent of the Franchise Tax Board.

### ***Making the Election***

The election can be made by using:

- [Form FTB 3805Z](#) - Enterprise Zone Deduction and Credit Summary

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## CALIFORNIA FRANCHISE TAX BOARD

### ***Members of an Affiliated Group References 24356.7(c)(5); 24356.7(c)(6)***

For purposes of electing the business expense deduction, all members of an affiliated group shall be treated as one taxpayer. The maximum deduction amount shall be properly apportioned among the members of the affiliated group.

An affiliated group is defined in IRC 1504 as modified by the California Revenue & Taxation Code, to replace "at least 80%" with "more than 50%" each place it appears in IRC 1504(a).

## **I. DEPRECIATION**

The basis (cost for depreciation purposes) of the property must be reduced by the amount allowed as a deduction. Normal depreciation is allowed on the cost of the property in excess of the expensed amount. The taxpayer may use any method that is allowable for California purposes, beginning with the income or taxable year following the year in which the property is placed in service.

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation allowed under IRC Section 179 / CRTC 24356 for the same property.

## **J. CREATING A NET OPERATING LOSS**

Unlike IRC Section 179, there is *no* statutory prohibition on the amount of business expense deduction that may create a net operating loss.

## **K. ALTERNATIVE MINIMUM TAX**

***References 17062; 23457***

The business expense deduction is *not* listed as a tax preference item.

## **L. RECAPTURE**

***References 17267.2(h); 24356.7(g)***

The business expense deduction is subject to recapture (added back to income) if, before the *close of the second income or taxable year after* the property is placed in service, the property is sold, disposed of, or is no longer used exclusively within the EZ trade or business.

To recapture the amount deducted, add to the current year income, the amount previously deducted for that property.

***Example:*** Corp. A purchases property on June 1, 1998 which qualifies Corp. A to take the EZ business expense deduction. Corp. A's income year ends December

## CALIFORNIA FRANCHISE TAX BOARD

31 of each year. Corp. A disposes of the property August 5, 2000. The previous deduction is added to income in the 2000 tax year because the property was disposed of before the close of the second income or taxable year after the property was placed in service, 12/31/2000.

### M. CHECKLIST FOR DETERMINING ELIGIBILITY FOR THE BUSINESS EXPENSE DEDUCTION

Checklist Items	Yes	No
Is the business qualified? <ul style="list-style-type: none"><li>Is a trade or business conducted within an EZ? See the <i>Qualified Taxpayer</i> section.</li></ul>		
Is the property qualified? <ul style="list-style-type: none"><li>Qualified property is Section 1245 property. See the <i>Qualified Property</i> section.</li><li>Is the property used exclusively within the boundaries of the EZ?</li></ul>		
Is the correct deduction amount claimed? <ul style="list-style-type: none"><li>Limitation differs based on the taxable or income year since zone designation. See <i>Deduction Amount</i> section.</li><li>Verify purchase on invoices or receipts.</li><li>Verify the date the property is placed in service.</li></ul>		
Was a timely election made? <ul style="list-style-type: none"><li>Election made on original return?</li><li>Form FTB 3805Z – Enterprise Zone Deduction and Credit Summary, or a separate statement attached to the return?</li></ul>		
Was the property acquired through a valid transaction? <ul style="list-style-type: none"><li>See the Property Not Qualified section.</li></ul>		
Was correct depreciation claimed? <ul style="list-style-type: none"><li>Basis must be reduced by the amount of the business expense deduction before depreciation is computed.</li><li>IRC Section 179 expense or additional first year depreciation may not be claimed for qualified property for which the business expense deduction is claimed.</li><li>A depreciation deduction on qualified property is not allowed in the same year the business expense</li></ul>		

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## CALIFORNIA FRANCHISE TAX BOARD

deduction is claimed.		
Is the deduction subject to recapture? <ul style="list-style-type: none"><li>• Was the property sold, disposed of or no longer used by the taxpayer in the zone, before the close of the second income or taxable year after the property was placed in service?</li><li>• Check current location of the qualified property.</li><li>• Check sale or disposal date of qualified property.</li></ul>		

### N. RECORD KEEPING REQUIREMENTS

To support the business expense deduction claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- the property purchased (such as serial numbers, etc.); and
- the location where the property is used

**CHAPTER 5 ENTERPRISE ZONE NET OPERATING LOSS****A. INTRODUCTION*****References 17276.1(a); 17276.2(a); 24416.1(a); 24416.2(a)***

Taxpayers are required to annually report their income and expenses. Due to possible fluctuations in income and expenses, a taxpayer may have substantial profits in one year, while losses in another. In years where expenses exceed income, a net operating loss (NOL) occurs.

For entities conducting business within an Enterprise Zone (EZ), a qualified taxpayer may elect to carry forward 100% of its NOL for a 15 year period.

An EZ NOL cannot be generated until the first taxable or income year beginning on or after the area has been officially designated as an EZ.

For taxable or income years beginning before January 1, 1997, the applicable EZ NOL code sections were:

- 17276 - 17276.1, 17276.2(b), 17276.3
- 24416 - 24416.1, 24416.2(b), 24416.3

For taxable or income years beginning on or after January 1, 1997, and before January 1, 1998, the applicable EZ NOL code sections were:

- 17276 - 17276.1, 17276.2(a), 17276.3
- 24416 - 24416.1, 24416.2(a), 24416.3

For taxable or income years beginning on or after January 1, 1998, the EZ NOL code sections are:

- 17276 - 17276.3
- 24416 - 24416.3

The following references in this chapter are to the new code section numbers.

***Geographic Boundaries***

For a listing of enterprise zones and designation dates, refer to Chapter 1, Section (d). For verifying an address, refer to Chapter 1, Section (c).

## CALIFORNIA FRANCHISE TAX BOARD

### **B. QUALIFIED TAXPAYER**

**References 17276.2(a); 24416.2(a)**

For purposes of the EZ NOL deduction, a qualified taxpayer includes a person or entity that is engaged in a trade or business within an EZ.

Taxpayers doing business in an area that was previously not a qualified area, but is later designated as qualified, are allowed to utilize the NOL for the taxable or income year beginning on or after the date the area received its designation as an EZ.

#### ***Pass-Through Entities***

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

### **C. ELECTION**

**References 17276.1(a)-(b); 17276.2(b)-(d); 24416.1(a) & (c); 24416.2(b)-(d)**

Qualified taxpayers must make an election to claim the EZ NOL. The election must be timely filed with the original return, and be for the income or taxable year in which the NOL is incurred. The election is irrevocable.

If the taxpayer is eligible to qualify for an NOL under more than one section (operating in more than one economic development area, new small business etc.), the taxpayer must choose which section to elect. Except for the loss incurred under the subdivision elected, taxpayers are prohibited from carrying over any other type of NOL from the same tax year.

Failure to elect to compute the NOL deduction under section 17276.1 or 24416.1 will cause the NOL to be subject to the limitations and restrictions under section 17276 or 24416 (general NOL).

#### ***Making the Election***

The election can be made by using:

Form FTB 3805Z – Enterprise Zone Deduction and Credit Summary.

In addition, the form FTB 3805Z must be filed for each year in which the NOL deduction is taken.

### **D. EZ NOL COMPUTATION - GENERAL PROVISIONS**

**References 17276.1(a); 17276.2(a)(2)(A); 24416.1(a); 24416.2(a)(2)(A)**

## CALIFORNIA FRANCHISE TAX BOARD

An EZ NOL is the loss attributable to the qualified taxpayer's business activities within an EZ, prior to the EZ expiration date. EZ NOLs are determined under IRC Section 172, as modified by the following CRTC Sections:

- 17276.1
- 17276.2
- 24416.1
- 24416.2

### **E. EZ NOL - LOSS ATTRIBUTED TO BUSINESS ACTIVITY**

#### ***References 17276.2(a)(2)(A) - (B); 24416.2(a)(2)(A) - (B)***

An EZ NOL is the loss attributable to the qualified taxpayer's business activities within the EZ prior to the EZ expiration date. Non-business income and/or loss are excluded from the calculation of the EZ NOL.

If a business is located within and outside of an EZ, or in more than one EZ, the taxpayer must determine the portion of the total business loss that is attributable to the EZ.

- Business loss is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1998, business loss is apportioned to the EZ by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning after January 1, 1996 and before January 1, 1998 (1996 fiscal year taxpayers, 1997 year taxpayers), business loss is apportioned to the EZ by use of a four-factor apportionment formula. Worldwide business loss is multiplied by a fraction, the numerator of which is the property factor, payroll factor, and the double-weighted sales factor. The denominator is four (4).

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991- 1995 year taxpayers and 1996 calendar year taxpayers), business loss is apportioned to the EZ by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning before January 1, 1991, business loss attributed to an EZ is determined by multiplying worldwide business loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

**(i) Property Factor – Loss Apportionment**

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the EZ* during the income or taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

**(ii) Payroll Factor – Loss Apportionment**

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the EZ during the income or taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

**(iii) Sales Factor – Loss Apportionment**

The sales factor is a fraction.

- The numerator of the sales factor is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayers trade or business in the EZ.
- The denominator is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

**Example** - Two-factor apportionment: For the income year ending 12/31/99, Corp. A operates within and outside an EZ. Corp. A's business loss of \$13,000

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 62 of 307

needs to be apportioned to the EZ. The following amounts apply to Corp. A's property and payroll:

EZ Property	\$40,000
Worldwide (WW) Property	\$100,000
EZ Payroll	\$5,000
WW Payroll	\$10,000

EZ Property/WW Property	= .40	
EZ Payroll/WW Payroll	= <u>.50</u>	
	.90/2 = .45	EZ Apportionment Factor

Business loss	\$(13,000)
Apportionment Factor	<u>x 0.45</u>
EZ NOL	\$(5,850)

**NOTE:** The four-factor apportionment formula is as follows:

Zone income = (property, payroll, & sales factors/ 4) x worldwide business income.

Property factor = zone property/worldwide property

Payroll factor = zone payroll/worldwide payroll

Sales Factor = zone sales/worldwide sales x 2

### (iv) Apportionment – Combined Groups

For members of a combined group, the EZ NOL calculation will be based on the combined groups worldwide business loss (before CA apportionment). The numerator of the apportionment formula will be based on each enterprise zone taxpayer's separate enterprise zone payroll and property amounts (and sales as discussed in Section (e)(iii)), and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in Section (e)(iii)).

**Example:** For the income year ending 12/31/99, Parent corporation A has two subsidiaries, B and C. Corporations A and B operate within an EZ. The combined group operates within and outside California and apportions its income or loss to California using Schedule R. The combined group's business loss is \$1,000,000.

Business loss apportioned to the EZ was determined as follows:

A	B	C	Combined
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# CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 63 of 307

## Property Factor

EZ Property	\$2,000,000	\$1,000,000	\$0	\$3,000,000
Worldwide Property				\$5,000,000
Apportionment %	40%	20%		60%

## Payroll Factor

EZ Payroll	\$2,000,000	\$800,000	\$0	\$2,800,000
Worldwide Payroll				\$4,000,000
Apportionment %	50%	20%		70%

Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
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Business Loss				\$(1,000,000)
EZ NOL	\$(450,000)	\$(200,000)		\$(650,000)

## (v) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an EZ and one outside the EZ. Eighty percent (80%) of the S corporation's business is attributable to the EZ. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the EZ.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary Loss	200,000
EZ business expense deduction	(5,000)*

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## CALIFORNIA FRANCHISE TAX BOARD

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Ray's unreimbursed employee expenses from Schedule A	(2,000)
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\*The EZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's EZ loss is computed as follows:

Ray's EZ salary (\$100,000 x 50%)	\$50,000
Mary's EZ salary (\$75,000 x 100%)	75,000
Pass-through ordinary loss from the S-Corp. (\$200,000 x 80%)	(160,000)
EZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	<u>(1,000)</u>
Total EZ loss	<u>\$(41,000)</u>

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of EZ NOL since they are not related to trade or business activities.

### F. EZ NOL LIMITED BY GENERAL NOL

#### **References 17276; 24416**

The EZ NOL computed as discussed in Section (e) is compared to the NOL computed under the general NOL provisions of section 17276 / 24416, *prior to the 50% reduction*. The EZ NOL carryover is limited to the lesser of the EZ NOL or the general NOL (prior to the 50% reduction). NOTE: If the EZ NOL is limited by the general NOL amount, (prior to the 50% reduction), the amount can still be characterized as an EZ NOL and allowed to be carried over at 100% for 15 years. An election must be made to characterize the NOL as an EZ NOL.

**Example:** Corp. B incurred the following loss:

Income from business operations	\$160,000
Interest from investment which is unrelated to Corp. B's business operations	15,000
Expenses of business operations	<u>(189,000)</u>
Net loss	<u>(\$14,000)</u>

To determine the NOL carryover attributed to the EZ business operations, the following must be done:

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## CALIFORNIA FRANCHISE TAX BOARD

1. Determine NOL per CRTC 24416 (prior to 50% reduction)
2. Determine NOL per CRTC 24416.2

The NOL carryover is limited to the lesser of the general NOL (item 1) or the EZ NOL (item 2) above.

1. CRTC 24416 "general" NOL - prior to 50% reduction  
Net loss of Corp. B (\$14,000)
2. CRTC 24416.2 EZ NOL - exclude non-business income/loss  
Income from operations \$160,000  
Expenses of operations (189,000)  
Net loss of Corp. B (EZ) (\$29,000)

Pattern 1: Assume Corp. B operates entirely within the EZ. Corp. B is allowed to carry over the lesser of the "general" NOL, or the EZ NOL; in this case \$14,000.

Pattern 2: Assume Corp. B conducts 40% of its total business operations in the EZ, as computed as discussed in Section (e). Because Corp. B only has 40% of its business operation in the EZ, the \$29,000 business loss must be apportioned before comparing it to the "general" NOL. In this example, the EZ loss is \$11,600 (\$29,000 x 40%). Corp. B is allowed to carry over the lesser of the "general" NOL, or the EZ NOL; in this case, \$11,600.

### **G. CARRYOVER / CARRYBACK**

#### ***References 17276.1(a); 24416.1(a)***

For each income or taxable year a qualified taxpayer engaged in a trade or business within a designated EZ may elect to carryover 100% of its NOL. No NOL carrybacks are allowed.

The NOLs may be carried over to each of the 15 income or taxable years following the year of loss, or until exhausted, whichever occurs first. If an NOL carryover remains after the EZ designation has expired, the EZ shall be deemed to remain in existence for purposes of computing the EZ income limitation, and for purposes of allowing the EZ NOL deduction.

NOTE: Financial institutions, as defined in IRC Sections 585, 586, or 593, using bad debt reserve methods may carry the loss forward for a maximum of 5 income years.

#### ***Carryover from Years Prior to January 1, 1997***

#### ***References 17276.1(c); 24416.1(d)***

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## CALIFORNIA FRANCHISE TAX BOARD

For taxable or income years beginning on or after January 1, 1997, the EZ incentives were repealed and replaced by new EZ incentives. However, any EZ NOL carryover attributable to taxable or income years beginning *prior* to January 1, 1997 shall, if previously elected, continue to be carried over as an EZ NOL carryover amount.

### H. NOL DEDUCTION - GENERAL PROVISIONS

**References 17276.2(a)(2)(B); 17276.2(a)(2)(C)(ii); 24416.2(a)(2)(B); 24416.2(a)(2)(C)(ii)**

The EZ NOL deduction can only *offset business income attributable to operations of the taxpayer within the designated EZ*.

In the event an EZ NOL deduction is allowable for any taxable or income year after the EZ designation has expired, the EZ will be deemed to remain in existence for the purpose of computing the business income limitation and allowing an EZ NOL deduction.

#### (i) Income Attributed to Business Activity

**References 17276.2(a)(2)(C); 24416.2(a)(2)(C)**

If a business is located within and outside of an EZ, or in more than one EZ, the taxpayer must determine the portion of the total business income that is attributable to the EZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1998, business income shall be apportioned to the EZ by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning after January 1, 1996 and before January 1, 1998 (1996 fiscal year taxpayers, 1997 year taxpayers), business income is apportioned to the EZ by use of a four-factor apportionment formula. Worldwide business income is multiplied by a fraction, the numerator of which is the property factor, payroll factor, and the double-weighted sales factor. The denominator is four (4).

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991- 1995 year taxpayers and 1996 calendar year taxpayers), business income is apportioned to the EZ by multiplying the

worldwide business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning before January 1, 1991, income or loss attributed to an EZ is determined by multiplying worldwide business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

**(ii) Property Factor – Income Apportionment**

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the EZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.
- For income or taxable years beginning before January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

**(iii) Payroll Factor – Income Apportionment**

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the EZ during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1998, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.
- For income or taxable years beginning before January 1, 1998, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

**(iv) Sales Factor – Income Apportionment**

The sales factor is a fraction.

- The numerator of the sales factor is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the

## CALIFORNIA FRANCHISE TAX BOARD

taxable or income year from transactions and activities occurring within the taxpayer's trade or business in the EZ.

- The denominator is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

**Example** - Two-factor apportionment: For the income year ending 12/31/99, Corp. A operates within and outside an EZ. California business income of \$13,000 needs to be apportioned to the EZ. The following amounts apply to Corp. A's property and payroll:

EZ Property	\$40,000
CA Property	\$100,000
EZ Payroll	\$5,000
CA Payroll	\$10,000

EZ Property/CA Property	=.40	
EZ Payroll/CA Payroll	= <u>.50</u>	
	.90/2 = .45	EZ Apportionment Factor

Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
EZ Business Income	\$5,850

**NOTE:** The four-factor apportionment formula is as follows:

Zone income = (property, payroll, & sales factors/ 4) x worldwide business income.

Property factor = zone property/worldwide property

Payroll factor = zone payroll/worldwide payroll

Sales Factor = zone sales/worldwide sales x 2

### (v) Apportionment – Combined Groups

For income or taxable years beginning before January 1, 1998: For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each enterprise zone taxpayer's separate enterprise zone payroll and property amounts (and sales as previously discussed), and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as previously discussed).

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## CALIFORNIA FRANCHISE TAX BOARD

For an example of apportionment under this method refer to Chapter 23, Section (g)(iv).

For income or taxable years beginning on or after 1/1/1998: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the enterprise zone. The numerator of the apportionment formula will be based on each enterprise zone taxpayer's separate enterprise zone property and payroll amounts and the denominator will be based on each enterprise zone taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the EZ. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate EZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the EZ was determined as follows:

	A	B
<u>Property Factor</u>		
EZ Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
EZ Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
Average Apport. % (Property + Payroll Factors)/2	100%	73.33%
Apportioned Business Income	\$228,000	\$250,000
EZ Income	\$228,000	\$183,333

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## CALIFORNIA FRANCHISE TAX BOARD

### (vi) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an EZ and one outside the EZ. Eighty percent (80%) of the S corporation's business is attributable to the EZ. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the EZ.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
EZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The EZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's EZ income is computed as follows:

Ray's EZ salary (\$100,000 x 50%)	\$50,000
Mary's EZ salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp.	
(\$40,000 x 80%)	32,000
EZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	(1,000)
Total EZ income	\$151,000

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 71 of 307

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of EZ income since they are not related to trade or business activities.

### **I. NOL SUSPENSIONS**

**References 17276.3(c); 24416.3(c)**

NOLs incurred by qualified taxpayers are *not* suspended for taxable or income years beginning in 1991 and 1992.

### **J S CORPORATIONS**

**References 23802(d)(1)-(2)**

For qualified taxpayers electing S corporation status *after* the designation of the EZ, the qualified NOL attributed to the C corporation years cannot offset S corporation net income.

### **K. ALTERNATIVE MINIMUM TAX**

**References 17062; 23456**

Taxpayers claiming an EZ NOL deduction must also determine their NOL for alternative minimum tax purposes.

### **L. FLOW-THROUGH LOSSES**

**References 17087.5; 17087.6; 17851; 23800; 24271**

The income and loss that will flow through to a shareholder, beneficiary, partner, or member, retains the same characteristics as it had with the pass-through entity.

The election (Section C) to claim an NOL must be made by the entity and each investor on their respective returns. The election by the entity to utilize the EZ NOL does not extend to, or bind the investor to utilizing the EZ NOL. Further, the investor may utilize the EZ NOL if the entity utilized the general NOL provisions, or had no NOL. Each taxpayer must determine if they in fact have a NOL, and then decide whether the general or EZ NOL will be utilized.

**CHAPTER 6 ENTERPRISE ZONES NET INTEREST DEDUCTION****A. INTRODUCTION**

California Revenue & Taxation Code (CRTC) Sections 17235 and 24384.5 provide for the deduction of net interest income for loans made to a trade or business located solely within an Enterprise Zone (EZ). The net interest deduction is for interest payments received after the designation of the EZ and before its expiration.

***Legislative History***

Prior to January 1, 1997, the applicable EZ net interest deduction code sections were:

- 17231
- 24384

For taxable or income years beginning on or after January 1, 1997, the EZ net interest deduction code sections are:

- 17235
- 24384.5

The following references in this chapter are to the new code section numbers. However, subdivision and paragraph numbering between the old and new code sections should parallel.

***Geographic Boundaries***

For a listing of enterprise zones and designation dates, refer to Chapter 1, Section (d). For verifying an address, refer to Chapter 1, Section (c).

**B. QUALIFIED TAXPAYER*****References 17235(a)&(b); 24384.5(a)&(b)***

For purposes of the EZ net interest deduction, a qualified taxpayer includes a person or entity (creditor) that loans funds on or after the designation date of the EZ to a qualified business/debtor and receives interest payments thereon. The loan advanced to the qualified business/debtor must also meet the requirements as discussed in Section (c).



The creditor does not have to be located in the EZ to take advantage of the net interest deduction. Only the debtor needs to operate in the EZ.

***Pass-Through Entities***

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

**C. QUALIFIED DEBT**

***References 17235(b); 24384.5(b)***

To claim the net interest deduction for creditors, the following requirements must be met at the time the indebtedness is incurred:

- The trade or business (*qualified business/debtor*) to which the loan is made, must be located solely within an EZ;
- The indebtedness is incurred solely in connection with activity within the EZ; and
- The creditor has no equity or other ownership interest in the debtor.

**NOTE:** Repealed Sections 17235(b) & 24384.5(b) require that the creditor have no equity or other ownership interest in the debtor at the time the loan is made. However, the CRTC does not provide for any limitation after the loan is made. For example, assume that two years after the qualified loan is made the debtor contacts the creditor to renegotiate the loan terms due to the debtor's poor financial condition. The creditor agrees to take an equity interest in the debtor in exchange for reducing the amount due from the debtor. Net interest received from the remaining portion of the qualified loan would still be deductible.

To claim the net interest deduction for creditors, the following requirements must be met annually:

- The qualified business/debtor that the loan was made to and interest payments are received from, must be conducting business in the EZ.

***Example: Two years after the qualified loan is funded, the qualified business/debtor moves their operations entirely outside of the EZ geographic boundaries. The net interest deduction is no longer allowed because the trade or business is not located within the designated EZ.***

***Security/Collateral***

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

The statute does not require that the security or collateral for the loan be located in the EZ. For example, a sole proprietor can use its personal residence as collateral for the EZ business loan and the creditor would still be allowed the net interest deduction assuming all other qualifications are met.

***Definition of "Qualified Business/Debtor"***

The definition of a *qualified business/debtor* requires inquiry at the entity level. The business activity of the entity (entirely or a portion thereof as relevant) must be conducted within the EZ.

***Definition of a "Trade or Business"***

Black's Law Dictionary defines *trade or business* as follows:

*"Any business or professional activity conducted by a taxpayer, the objective of which is to earn a profit. The general test for determining whether a person is engaged in "trade or business" so as to be entitled to deduct expenses as trade or business expenses under the Internal Revenue Code is whether the taxpayer's primary purpose and intention in engaging in the activity are to make a profit."*

***Definition of "Located Solely Within"***

***References 17235(b)(1); 24384.5(b)(1)***

In order to claim the net interest deduction, the loan must be made to a qualified business *located solely within* an EZ. Generally, one looks to the presence of tangible property in order to determine the place, site, or limits of a business. Intangible property by definition cannot be located by reference to physical presence. The presence of all of the qualified trade or business' payroll and tangible property within an EZ would be a strong indication that they meet the test. The fact that sales are delivered by common carrier outside of the EZ should not cause the borrower to fail the "*located solely within*" requirement.

**D. NET INTEREST DEDUCTION - COMPUTATION**

***Net Interest***

For purposes of determining the net interest deduction, *net interest* is gross interest received less related interest expense (cost of funds) and any other directly related expenses.

***Gross Interest***

There may be substantial differences between *tax* and *book* accounting methods. Consequently, the amount of gross interest income included in the computation of net interest must be determined using the creditor's tax accounting method

## CALIFORNIA FRANCHISE TAX BOARD

(i.e., the gross interest income included in the computation of net interest corresponds to the gross interest income included in the determination of taxable income). Gross interest income should not include items that are *not* in the nature of interest.

Interest is defined as an amount paid for the use or forbearance of money.

Gross interest may be determined by referencing the loan contract. A contract between a creditor and a qualified trade or business may include all of the following:

- A stated rate of interest;
- Points;
- Commitment fees (fees for entering into an agreement that obligates the lender to make funds available for an agreed period at a stated rate of interest - see Rev. Rul. 70-540)\*;
- Service fees (fee charged for processing a loan); and
- Escrow interest.

Analysis of each of the above items is necessary to determine which are in the nature of interest. For example, commitment fees and service fees should not be included in gross interest for purposes of determining the net interest deduction as they are fees earned when establishing the loan and are not monies paid for the use of the loaned funds.

Points are a charge by the lender, in addition to the stated rate of interest, to reflect the actual cost of borrowing money. Thus, points as here described, are for the use or forbearance of money and are considered to be interest. Escrow interest is interest from the date the loan is funded until 30 days before the borrower's first loan payment. Original issue discount (OID) is another form of interest. Stated interest, points, escrow interest, and OID are all items that may be included in gross interest for purposes of determining the net interest deduction.

**\*NOTE:** Revenue Ruling 70-540, 1970-2 CB 101 discusses the character of commitment fees from the lender's point of view. The commitment fee is a charge for agreeing to make funds available rather than for the use or forbearance of money, and therefore, is not interest. Other revenue rulings discuss commitment fees from the point of view of the borrower. To the extent of any discussion concerning the treatment of points by the lender, Rev. Rul. 70-540 was made obsolete by Rev. Proc. 94-29, 1994-1 CB 616; this does not effect its relevance in regards to commitment fees.

## CALIFORNIA FRANCHISE TAX BOARD

### ***Cost of Funds***

A reasonable amount of interest expense must be assigned to the interest income. One method of determining a reasonable cost of funds would be the following formula:

$$\frac{\text{Interest Expense}}{\text{Funding Sources}} = \text{Cost of Funds}$$

Funding sources are equal to average liabilities plus owners' equity less average non-interest earning assets.

The ratio from the above formula would be multiplied by the average loan principal outstanding for the year. All amounts should be on a tax basis.

For example, assume the following is from the tax return of a financial institution:

Average liabilities and owners' equity	\$53,000,000,000
LESS: Average non-interest earning assets	<u>7,000,000,000</u>
Funding Sources	\$46,000,000,000
 Total Interest Expense	 <u>\$ 1,500,000,000</u>
Funding Sources	\$46,000,000,000 = 3.26%

Assume that an average principal amount of \$10 million was outstanding during the year for loans made to businesses within an EZ. A reasonable amount of interest expense to assign to the loans is \$326,000 (\$10 million times 3.26%).

Taxpayers may also use an independent cost of funds index such as the prime index rate or the London Interbank Offered Rate (LIBOR), which is the rate banks use to place Eurodollars with one another in London. If an independent index is used, that index must approximate the taxpayer's cost of funds.

The annual report of many banks or savings and loan associations provides the average cost of funds. The net interest margin (the difference between interest income and interest expense) is usually of interest to shareholders and other users of the annual report. The net interest margin should be similar to that used for the calculation of the net interest deduction.

### ***Other Related Expenses***

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## CALIFORNIA FRANCHISE TAX BOARD

"Net interest" is interest received less the cost of funds and direct expenses incurred in earning such interest. An example of a direct expense is commission paid to a loan representative. Expenses that are not directly attributable to the loan in question should not be subtracted for purposes of determining the net interest deduction.

All reasonably identifiable direct costs applicable to acquiring or making a loan should be capitalized and written off over the life of the loan. The amortization method should reflect the nature of the loan. It would be reasonable to use straight line or principal reduction methods of amortization (see Rev. Proc. 94-29 for application of the principal reduction method).

### ***Non-Bank & Financial Lenders***

Non-financial corporations and individuals usually do not have all of the various income and expense items referred to previously.

Generally, gross interest of non-bank or non-financial creditors will be the interest income as stated in the loan. For example, an individual creditor will generally avoid escrow interest by establishing the monthly due date of the loan as the day of the month the loan was funded, or the day escrow closed, whereas mortgages carried by a commercial lender generally have a common due date, i.e., the beginning of the month.

Related expenses, such as the cost of funds, must be determined in order to compute the deduction of net interest income. Non-bank or non-financial lenders who make loans to qualified businesses located solely within the EZ may incur investment interest expense related to such loans. The interest tracing rules under Treas. Reg. 1.163-8T are appropriate for determining related interest expense for these taxpayers.

## **E. EXPIRATION OF EZ DESIGNATION**

### ***References 17233; 24385***

Once the EZ designation expires, becomes inoperative, or ceases to exist, the net interest deduction is not allowed because the trade or business is no longer located within the designated EZ.

## **F. RECORD KEEPING**

The qualified taxpayer/creditor should maintain records on each loan (loan agreements) for which a deduction of net interest has been taken that identifies or describes:

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## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 78 of 307

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- the debtor,
- the debtor's location (at the time of indebtedness and annually),
- the debtor's mailing address,
- the purpose/use of the loan,
- the stated interest,
- other items included in gross interest,
- any direct expenses associated with the loan, and
- any property securing the loan.

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**CHAPTER 7 ENTERPRISE ZONE EMPLOYEE WAGE CREDIT****A. INTRODUCTION*****References 17053.75, 17053.9 (Repealed)***

For each taxable year beginning on or after January 1, 1984, a credit is available to "qualified" employees, who earn "qualified" wages. The credit is equal to 5% of the employees "qualified" wages for the year. The maximum credit may not exceed \$525.

**B. QUALIFIED EMPLOYEE**

A qualified employee is one that meets all of the following requirements:

1. At least 90% of the employee's work time is spent on activities that are directly related to the conduct of a trade or business within an Enterprise Zone.
2. At least 50% of the employee's work is performed within an Enterprise Zone.
3. The employee is *not* an employee of the federal government, the state of California, or a local government.

For information about the geographic boundaries of an EZ, refer to Chapter 1, Sections (c) and (d).

**C. QUALIFIED WAGES**

Qualified wages are those wages attributable to services performed by a qualified employee that do not exceed \$10,500 for any taxable year. Qualified wages do not include compensation received from the federal government, the state of California, or a local government. In addition, qualified wages do not include any wages received on or after the date the Enterprise Zone designation expires, is no longer binding, or becomes inoperative.

**D. CREDIT LIMITATIONS & INCOME LIMITATION*****Credit Limitation***

The maximum amount of qualifying wages is \$10,500. For each dollar of income received by the employee that is in excess of the qualified wages (\$10,500), the credit shall be reduced by nine cents (\$0.09).

***Zone Income Limitation***

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 80 of 307

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For each eligible taxable year, the credit may only offset taxes due on the income earned within the Enterprise Zone.

### ***Credit Usage and Carryover***

This credit may not reduce regular tax below the tentative minimum tax (TMT).

There are no carryover provisions for the Enterprise Zone Employee Wage credit. Any unused is not refundable and the credit may not be carried over to succeeding tax years.



**CHAPTER 8 TARGETED TAX AREA HIRING CREDIT****A. INTRODUCTION*****References 17053.34; 23634***

For each taxable or income year beginning on or after January 1, 1998, the California Revenue & Taxation Code (CRTC) provides a hiring credit for "qualified" taxpayers who operate or invest in a business located within the designated Target Tax Area (TTA) hire "qualified employees" and pay them "qualified wages". The TTA was established in California to stimulate development selected economically depressed areas.

The TTA hiring credit applies to those employees hired after the designation date of the TTA.

***TTA Locations and Designation Date***

For a listing of TTA cities, refer to Chapter 1, Section (g). To verify an address, refer to Chapter 1, Section (c).

**B. QUALIFIED TAXPAYER*****References 17053.34(b)(5)(A); 23634(b)(5)(A)***

*A qualified taxpayer is:*

- A person or entity that is engaged in a trade or business within the TTA and whose trade or business is described in the following Standard Industrial Classification (SIC) Manual (1987 edition) code sections:
  - Codes 2000 through 2099
  - Codes 2200 through 3999
  - Codes 4200 through 4299
  - Codes 4500 through 4599
  - Codes 4700 through 5199
- Obtains and retains certification as discussed in Section (e) which provides that a qualified employee meets the eligibility requirements applicable immediately preceding commencement of employment with the taxpayer as discussed in Section (d).

***Pass-Through Entities***

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S

corporation. The hiring tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

***Controlled Groups******References 17053.34(e)(1); 23634(e)(1)***

All employees of trades or businesses that are under common control, or members of the same controlled group of corporations, shall be treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC 1563(a) as modified by the California Revenue & Taxation Code, to replace "*at least 80%*" with "*more than 50%*". The determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of IRC Section 1563.

**NOTE:** Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

***Acquired Businesses******References 17053.34(e)(2); 23634(e)(2)***

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues to be employed in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues to be employed in that business.

**NOTE:** The new employer, "steps into the shoes" of the old employer for purposes of incurring future credits.

**C. QUALIFIED WAGES*****References 17053.34(b)(1); 17053.34(b)(2); 17053.34(g); 23634(b)(1); 23634(b)(2)***

*Qualified wages* are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer. For qualified employees hired before the expiration date of the TTA, qualified wages paid or incurred within the 60-month period beginning with the first day the employee commences employment with the taxpayer shall continue to qualify for the credit after the zone expiration date, as if the TTA designation were still in existence and binding.

## CALIFORNIA FRANCHISE TAX BOARD

Qualified *wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

### ***Estates and Trusts***

In the case of an estate or trust, the qualified wages shall be apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages have been apportioned, shall be treated as the employer with respect to those wages.

### ***Non-Qualified Wages***

Qualified wages *do not* include any wages paid or incurred on or after the area expiration date except as noted previously for qualified employees hired prior to the expiration of the TTA.

### ***Minimum Wage Chart***

EFFECTIVE DATE	MINIMUM WAGE	MAXIMUM HOURLY WAGE – HIRING CREDIT
March 1, 1998 to Current	\$5.75	\$8.62 (150% of \$5.75)

## **D. QUALIFIED EMPLOYEE**

***References 17053.34(b)(4)(A); 23634(b)(4)(A)***

A qualified employee is an individual who satisfies all of the following:

### **ANNUAL TESTS**

- At least 90% of the individual's work for the taxpayer, during the taxable or income year, must be directly related to the conduct of the taxpayer's trade or business located within the TTA; and
- At least 50 percent of the individual's services for the taxpayer, during the taxable or income year, must be performed within the boundaries of the TTA;

### **TIME OF HIRE TESTS**

- The individual is hired after the area was designated as a TTA; and
- Immediately prior to commencement of employment with the taxpayer, the individual is any of the following:

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## CALIFORNIA FRANCHISE TAX BOARD

1. Eligible for services under the federal Job Training Partnership Act (JTPA) or its successor;
2. Eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor;
3. An economically disadvantaged individual 14 years of age or older;
4. A qualified dislocated worker (refer to the CRTC or the 3809 Business Booklet for an expanded definition);
5. A disabled individual who is eligible for, enrolled in, or who has completed a state rehabilitation plan;
6. A service-connected disabled veteran;
7. A veteran of the Vietnam era;
8. A veteran who recently separated from military service;
9. An ex-offender;
10. A person eligible for, or a recipient of any of the following:
  - Federal Supplemental Security Income (SSI) benefits;
  - Aid to Families with Dependent Children (AFDC);
  - Food stamps; or
  - State and local general assistance.
11. A Native American;
12. A resident of the TTA; or
13. A member of a targeted group, as defined in IRC Section 51(d), or its successor.

### ***Seasonal Employees***

**References 17053.34(b)(1)(B); 17053.34(b)(6); 23634(b)(1)(B); 23634(b)(6)**  
"Seasonal employment" means employment that has regular and predictable substantial reductions in business operations.

Reemployment of an individual, in connection with any increase (including a regularly occurring seasonal increase) in business operations, does not constitute commencement of employment for purposes of the TTA hiring credit.

### ***Leased Employees***

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer can be identified due to the legal obligation to pay the payroll taxes of the employee, and as to who has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, Employer's Supplemental Tax Guide provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship.

## CALIFORNIA FRANCHISE TAX BOARD

### E. VOUCHERING FORM TCA TTA1

**References 17053.34(d); 23634(d)**

The *Form TCA TTA1* is the certification, which provides that the qualified employee meets the eligibility requirements of a qualified employee as discussed in Section (d). The qualified taxpayer shall get *Form TCA TTA1* from one of the following applicable entities:

- The Employment Development Department (EDD);
- The local county JTPA administrative entity;
- The local city JTPA administrative entity;
- The local county GAIN office; or
- The social services agency.

EDD may provide preliminary screening and referral to the certifying agency. The qualified taxpayer needs to retain a copy of the certification and provide it upon request to the Franchise Tax Board.

### F. CREDIT COMPUTATION

**References 17053.34(a); 23634(a)**

For each income or taxable year beginning on or after January 1, 1998, a hiring credit shall be allowed to a qualified taxpayer for hiring a qualified employee for employment within the TTA. The credit shall be equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit will be used.

**Example:** An employee was hired 7/1/1998, and the taxpayer is completing the tax return for the year ending 12/31/1999. For the period 1/1/1999 to 6/30/1999, the hiring credit is based on 50% of qualified

## CALIFORNIA FRANCHISE TAX BOARD

wages. For the period 7/1/1999 to 12/31/1999, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

**Example:** An employee is hired 7/1/1998, is temporarily laid off 2/1/1999, and is rehired 4/1/1999. The 50% credit range runs from 7/1/1998 to 6/30/1999 regardless of the layoff period between 2/1/1999 and 3/31/1999.

### G. CREDIT LIMITATION - EXCLUSIVE CREDIT

**References 17053.34(c); 23634(c)**

If the qualified taxpayer is allowed the TTA hiring credit for qualified wages paid to an employee, only that one credit is allowed to the taxpayer with respect to those qualified wages for that employee.

### H. WAGE EXPENSE REDUCTION

**References 17053.34; 23634**

There is no corresponding wage expense reduction if a taxpayer utilizes the TTA hiring credit.

### I. BUSINESS INCOME ACTIVITY LIMITATION

**References 17053.34(j); 23634(j)**

The amount of hiring credit or the sales or use tax credit (see Chapter 9) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the TTA business income in any year. The TTA business income is that portion of the taxpayer's *California source* business income that is apportioned to the TTA. Non-business income or loss is not included in the calculation of business income from the TTA.

**Example:** Corp. A operates entirely within the TTA. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	\$2,000

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 87 of 307

---

Business expenses	<u>(17,000)</u>
Net Taxable Income	\$15,000

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	<u>(17,000)</u>
Net Business Income	\$13,000

To determine the TTA hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	\$13,000
x 8.84%	<u>x .0884</u>
Tax associated with business income	\$1,149

In this example, the taxpayer can offset the tax of \$1,149 with the hiring credit available (up to \$1,149).

**NOTE:** "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

### **J. GENERAL PROVISIONS – APPORTIONMENT OF BUSINESS INCOME** **References 17053.34(j)(2); 23634(j)(2); 23634(j)(3)**

If a business is located within and outside of a TTA, the taxpayer must determine the portion of the total business income that is attributable to each TTA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1998, business income shall be apportioned to the TTA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

#### **(i) Property Factor – Income Apportionment**

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the TTA* during the income or taxable year. The denominator is the average value of all real and tangible

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## CALIFORNIA FRANCHISE TAX BOARD

personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

### (ii) Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the TTA* during the income or taxable year. The denominator is the total compensation paid to employees working for the taxpayer *within California* during the income or taxable year.

**Example:** Corp. A operates within and outside a TTA. California business income of \$13,000 needs to be apportioned to the TTA. The following amounts apply to Corp. A's property and payroll:

TTA Property	\$40,000
CA Property	\$100,000
TTA Payroll	\$5,000
CA Payroll	\$10,000
TTA Property/CA Property	=.40
TTA Payroll/CA Payroll	= <u>.50</u>
	.90/2 = .45
	TTA Apportionment Factor
Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
TTA Business Income	\$5,850
Current Tax Rate	<u>x .0884</u>
Tax attributable to TTA business income	\$517

### (iii) Apportionment – Combined Groups

For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the TTA. The numerator of the apportionment formula will be based on each TTA taxpayer's separate TTA property and payroll amounts and the denominator will be based on each TTA taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the TTA. The



## CALIFORNIA FRANCHISE TAX BOARD

combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate TTA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the TTA was determined as follows:

	A	B
<u>Property Factor</u>		
TTA Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
TTA Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
Average Apport. %	100%	73.33%
(Property + Payroll Factors)/2		
Apportioned Business Income	\$228,000	\$250,000
TTA Income	\$228,000	\$183,333

### (iv) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within a TTA and one outside the TTA. Eighty percent (80%) of the S corporation's business is attributable to the TTA. (**NOTE:** This percentage was determined by the S corporation, using Worksheet IV from the FTB 3809 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the TTA.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 90 of 307

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
TTA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The TTA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's TTA income is computed as follows:

Ray's TTA salary (\$100,000 x 50%)	\$50,000
Mary's TTA salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp.	
(\$40,000 x 80%)	32,000
TTA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	<u>(1,000)</u>
Total TTA income	\$151,000

Ray and Mary must compute the tax on the total TTA income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*; the 1999 tax on \$151,000 is \$10,659. The \$10,659 is the first limitation on TTA credits for the 1999 tax year. The second limitation on the credits is the *net tax* on all income.

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of TTA income since they are not related to trade or business activities.

### K. S CORPORATIONS

**References** 23803(a)(1)(A); 23803(a)(1)(F)

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## CALIFORNIA FRANCHISE TAX BOARD

An S corporation's hiring credit may reduce the TTA tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's TTA income.

One hundred percent (100%) of the TTA credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

### L. CREDIT USAGE & CARRYOVER

**References 17053.34(i); 17053.34(j)(1); 17053.34(j)(4); 23634(i); 23634(j)(1); 23634(j)(4)&(5)**

The total amount of the TTA hiring credit and sales or use tax credit, including any credit carryover from prior years, that may reduce the "tax"/"net tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the TTA, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the "tax"/"net tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

If a credit carryover remains after the TTA has expired or has been revoked, the TTA shall be deemed to remain in existence for purposes of computing the taxpayer's business income attributable to the TTA.

**Example:** A taxpayer has a \$4,900 TTA hiring credit. Tax imposed on TTA business income is \$4,700 and the taxpayer's overall "net tax"/"tax" is \$4,000. The taxpayer would be eligible to claim a \$4,000 maximum hiring credit.

Total hiring credit	\$4,900
Tax on TTA income	\$4,700
<b><u>First limitation:</u></b>	
Lesser of total credit or tax on TTA income	\$4,700
<b><u>Second limitation:</u></b>	
Lesser of tax on TTA income or "net tax"/"tax"	\$4,000
Maximum credit allowed:	
Lesser of <i>TTA tax limitation</i> or " <i>net tax</i> "/" <i>tax</i> " limitation	<u>\$4,000</u>
Total hiring credit	\$4,900
Maximum credit allowed	<u>\$4,000</u>

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 92 of 307

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Carryover	\$ 900
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### M. CREDIT WILL NOT REDUCE CERTAIN TAXES

The TTA hiring credit *cannot* reduce the:

- minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- built-in gains tax (S corporations);
- excess net passive income tax (S corporation); or
- alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries).

The TTA hiring credit can reduce the regular tax below tentative minimum tax (TMT).

### N. CREDIT RECAPTURE

**References** 17053.34(f)(1); 17053.34(f)(3); 23634(f)(1); 23634(f)(3)

#### ***Non-Seasonal Employees***

Except as discussed subsequently, recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods:

- The first 270 "days of employment" (whether or not consecutive); or
- Ninety (90) "days of employment" plus 270 calendar days.

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

#### ***Seasonal Employees***

For income or taxable years beginning on or after January 1, 1998, for seasonal employees, the taxpayer must recapture the amount of the credit if employment is terminated before the completion of 270 "days of employment" during the 60-month period beginning the day the employee commences employment with the taxpayer except as subsequently discussed.

To recapture the credit, the taxpayer must add the amount of credit previously claimed in all years to the tax for the tax year that includes the 60<sup>th</sup> month of employment.

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## CALIFORNIA FRANCHISE TAX BOARD

A “day of employment” includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

**NOTE:** Any increase in tax, due to credit recapture, cannot be offset by the current year hiring credit.

### ***Credit Recapture – Exceptions***

**References 17053.34(f)(2)(A); 17053.34(f)(2)(B); 23634(f)(2)(A); 23634(f)(2)(B)**

For both regular and seasonal employees, the credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business; or
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

### ***Change in the Form of the Trade or Business***

**References 17053.34(f)(2)(C); 23634(f)(2)(C)**

The employment relationship between the taxpayer and an employee shall not be treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues to be employed in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee shall not be treated as terminated. In addition, transactions in which IRC Section 381(a) applies will not trigger recapture if the employee continues to be employed by the acquiring corporation.

## **O. RECORD KEEPING REQUIREMENTS**

For each qualified employee, documentation showing:

- Voucher
- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed

## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 94 of 307

---

- Date employee was terminated, and reason why

**The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.**

**CHAPTER 9 TARGETED TAX AREA SALE OR USE TAX CREDIT****A. INTRODUCTION*****References 17053.33; 23633***

For each income or taxable year beginning on or after January 1, 1998, a qualified taxpayer engaged in a trade or business within a designated Targeted Tax Area (TTA) can take a credit for sales or use tax paid or incurred in connection with the purchase of qualified property.

The TTA sales or use tax credit applies to qualified property purchased after the designation date of the TTA.

- In any year, individuals may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first \$1 million of qualified property.
- In any year, corporations may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first \$20 million of qualified property. (See special rule for S corporations and shareholders in Section (i)).

No credit may be claimed for property purchased after the TTA designation expires, is revoked, is no longer binding, or becomes inoperative.

***TTA Locations and Designation Date***

For a listing of TTA cities, refer to Chapter 1, Section (g). To verify an address, refer to Chapter 1, Section (c).

**B. EXCLUSIVE CREDIT*****References 17053.33(c); 23633(c)***

If the TTA sales or use tax credit is claimed for the purchase of qualified property during the income or taxable year, no other credit shall be allowed with respect to that property.

**C. QUALIFIED TAXPAYER*****References 17053.33(b)(2)(A); 23633(b)(2)(A)***

A qualified taxpayer is a person or entity that is engaged in a trade or business within a TTA and whose trade or business is described in the following Standard Industrial Classification (SIC) Manual (1987 edition) code sections:

- Codes 2000 through 2099
- Codes 2200 through 3999

## CALIFORNIA FRANCHISE TAX BOARD

- Codes 4200 through 4299
- Codes 4500 through 4599
- Codes 4700 through 5199

### ***Pass-Through Entities***

The determination of whether a taxpayer is a *qualified taxpayer* is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The sales or use tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

### **D. QUALIFIED PROPERTY**

***References 17053.33(b)(1)(C); 17053.33(b)(1)(A); 23633(b)(1)(C); 23633(b)(1)(A)***

Qualified property must be used exclusively in the TTA and is defined as:

Machinery and machinery parts used for:

- fabricating, processing, assembling, and manufacturing;
- the production of renewable energy resources.
- Air or water pollution control mechanisms.

Generally, qualified machinery parts include those parts that are necessary for the operation of the machinery (e.g., a conveyor belt).

Excluded parts are those used to complete a certain job. They are typically expensed to cost of good sold or general expense accounts. (e.g., specialized drill blades and oil utilized for routine maintenance work).

Effective for taxable or income years beginning on or after January 1, 1998, the definition of qualified property also includes:

- data processing and communications equipment, such as computers, computer-automated drafting systems, copy machines, telephone systems, and fax machines; or
- motion picture manufacturing equipment central to production and post-production, such as cameras, audio recorders, and digital image and sound processing equipment.

### ***Leased Property***

Taxpayers who acquire property by lease arrangement may qualify for the sales or use tax credit. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the sales or use tax



## CALIFORNIA FRANCHISE TAX BOARD

credit. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

### **E. CREDIT COMPUTATION – ASSET VALUE LIMITATION**

**References 17053.33(a); 17053.33(b)(1)(B); 23633(a); 23633(b)(1)(B)**

The sales or use tax credit is equal to the amount of sales or use tax “paid or incurred” by the taxpayer in connection with the purchase and use of qualified property.

**Example:** Taxpayer spent \$53,750 to purchase machinery used in the taxpayer's business within the TTA. The sales tax paid on the purchase is \$3,750. The sales tax credit is \$3,750.

Individuals, estates or trusts, partnerships, and limited liability companies (LLCs) taxed as partnerships may claim a credit on the sales or use tax paid or incurred to purchase up to \$1 million of qualified property. Corporations may claim a credit on the sales or use tax paid or incurred to purchase up to \$20 million of qualified property. This limitation applies to each income or taxable year. (See special rule for S corporations and shareholders in Section (i)).

**NOTE:** Upon acquisition, if the taxpayer/purchaser was exempt from paying sales tax on the property under the California Revenue & Taxation Code (CRTC), then the taxpayer/purchaser did not pay or incur sales tax in connection with the purchase of the property to the extent of the exemption. Thus, the taxpayer/purchaser is not allowed to take the sales or use tax credit on the amount of the exemption.

#### ***Use Tax Paid on Qualified Property***

**References 17053.33(d); 23633(d)**

If a taxpayer, operating within a TTA, purchases property out of state and pays or incurs a use tax, the credit will be allowed only if qualified property of a comparable quality and price is not timely available for purchase in this state.

### **F. DEPRECIABLE BASIS**

**References 17053.33(f); 23633(f)**

Any taxpayer that elects to claim the sales or use tax credit, shall *not* increase the basis of the qualified property by the amount of the sales or use tax paid or incurred.

## CALIFORNIA FRANCHISE TAX BOARD

**Example:** Taxpayer spent \$53,750 to purchase machinery used in the taxpayer's business within the TTA. The sales tax included in the purchase price was \$3,750. The basis of the property is \$50,000 (\$53,750 less \$3,750 sales tax).

### G. BUSINESS INCOME ACTIVITY LIMITATION

**References 17053.33(g)(1); 23633(g)(1)**

The amount of sales or use tax credit or hiring credit (see Chapter 8) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the TTA business income in any year. The TTA business income is that portion of the taxpayer's *California source* business income that is apportioned to the TTA. Non-business income or loss is not included in the calculation of business income from the TTA.

**Example:** Corp. A operates exclusively within the TTA. In order to determine the amount of sales or use tax credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	\$2,000
Business expenses	<u>(17,000)</u>
Net Taxable Income	\$15,000

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	<u>(17,000)</u>
Net Business Income	\$13,000

To determine the sales or use tax credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	\$13,000
x 8.84%	<u>x .0884</u>
Tax associated with business income	\$1,149

In this example, the taxpayer can offset the tax of \$1,149 with the sales or use tax credit available (up to \$1,149).

NOTE: "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

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## CALIFORNIA FRANCHISE TAX BOARD

### H. GENERAL PROVISIONS – APPORTIONMENT OF BUSINESS INCOME *References 17053.33(g)(1); 17053.33(g)(3)(B); 23633(g)(1); 23633(g)(3)(B)*

If a business is located within and outside of a TTA, the taxpayer must determine the portion of the total business income that is attributable to each TTA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1998, business income shall be apportioned to the TTA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

#### (i) Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the TTA* during the income or taxable year. The denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

#### (ii) Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the TTA* during the income or taxable year. The denominator is the total compensation paid to employees working for the taxpayer *within California* during the income or taxable year.

**Example:** Corp. A operates within and outside a TTA. California business income of \$13,000 needs to be apportioned to the TTA. The following amounts apply to Corp. A's property and payroll:

TTA Property	\$40,000
CA Property	\$100,000
TTA Payroll	\$5,000
CA Payroll	\$10,000

**CALIFORNIA FRANCHISE TAX BOARD**

TTA Property/CA Property	=.40	
TTA Payroll/CA Payroll	= <u>.50</u>	
	.90/2 = .45	TTA Apportionment Factor
Business income		\$13,000
Apportionment Factor		<u>x 0.45</u>
TTA Business Income		\$5,850
Current Tax Rate		<u>x .0884</u>
Tax attributable to TTA business income		\$517

**(iii) Apportionment – Combined Groups**

For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the TTA. The numerator of the apportionment formula will be based on each TTA taxpayer's separate TTA property and payroll amounts and the denominator will be based on each TTA taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the TTA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate TTA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the TTA was determined as follows:

	A	B
<u>Property Factor</u>		
TTA Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
TTA Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
Average Apport. %	100%	73.33%

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 101 of 307

(Property + Payroll  
Factors)/2

Apportioned		
Business Income	\$228,000	\$250,000
TTA Income	\$228,000	\$183,333

### (iv) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within a TTA and one outside the TTA. Eighty percent (80%) of the S corporation's business is attributable to the TTA. (**NOTE:** This percentage was determined by the S corporation, using Worksheet IV from the FTB 3809 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the TTA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
TTA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The TTA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's TTA income is computed as follows:

Ray's TTA salary (\$100,000 x 50%)	\$50,000
Mary's TTA salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp.	32,000

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 102 of 307

---

(\$40,000 x 80%)	
TTA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	<u>(1,000)</u>
Total TTA income	\$151,000

Ray and Mary must compute the tax on the total TTA income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*, the 1999 tax on \$151,000 is \$10,659. The \$10,659 is the first limitation on TTA credits for the 1999 tax year. The second limitation on the credits is the *net tax* on all income.

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of TTA income since they are not related to trade or business activities.

### I. S CORPORATION & SHAREHOLDER CREDIT AMOUNTS

**References 17053.33(b)(1)(B); 17053.33(b)(2)(B); 23633(b)(1)(B); 23633(b)(2)(B); 23803**

S corporations operating within a TTA may claim a credit on the sales or use tax paid or incurred to purchase up to \$20 million of qualified property. This limitation applies to each income year. The S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's TTA income.

An S corporation's sales or use tax credit may reduce the TTA tax at both the corporate and shareholder levels. One hundred percent (100%) of the TTA credits are passed through to the S corporation shareholders. However, S corporation shareholders are only allowed to claim a credit on the sales or use tax paid or incurred on the purchase of up to \$1 million of qualified property of the S corporation for each taxable year. The shareholders claim their pro-rata share of this credit as recomputed under the California personal income tax law (Part 10).

The sales or use tax credit is first computed for the S corporation using the actual qualified acquisition costs not to exceed \$20 million. The amount of credit passing through to the shareholders is then computed using the actual qualified acquisition costs not to exceed \$1 million. This credit based on the \$1 million limitation is passed through to the shareholders based on their pro rata share. The Schedules K (100S) and K-1 (100S) must state the credit amounts allocable to the shareholders.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 103 of 307

**Example:** Corp. Z, an S corporation, purchases \$2 million of qualified property, and takes the TTA sales or use tax credit. Corp. Z is allowed to claim a sales or use tax credit of \$50,000 ( $\$2,000,000 \times 7.5\% \times 1/3 = \$50,000$ ). [Cost (not to exceed  $\$20,000,000 \times \text{sales tax rate} \times 1/3$  S corporation credit limitation)]

The corporation's two shareholders allocate between them a sales or use tax credit of \$75,000 ( $\$1,000,000 \times 7.5\% = \$75,000$ ). [Cost (not to exceed  $\$1,000,000 \times \text{sales tax rate}$ )]

### J. SALES OR USE TAX CREDIT AND THE HIRING CREDIT

**References 17053.33(g)(1); 23633(g)(1)**

The amount of credit(s) allowed, in any income or taxable year, when a taxpayer is eligible to take both the sales or use tax credit and the hiring credit, is limited to the amount of tax imposed on the TTA income. Thus, the taxpayer must aggregate the credits and limit the total amount of credits to tax imposed on the TTA income.

### K. CREDIT USAGE AND CARRYOVER

**References 17053.33(e), 17053.33(g)(1); 23633(e); 23633(g)(1)**

The portion of the credit that exceeds the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

The aggregate amount of the TTA credits, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the TTA, determined as if that income represented all of the income of the taxpayer.

**Example:** A taxpayer has \$4,900 in TTA credits (sales or use tax credit *and* hiring credit). Tax imposed on TTA business income is \$4,700 and the taxpayer's overall "net tax"/"tax" is \$4,000. The maximum amount of credit is limited to the lesser of the tax on the TTA business income, or the tax on the taxpayer's overall "net tax"/"tax".

Total TTA credit	\$4,900
Tax on TTA income	\$4,700
<b><u>First limitation:</u></b>	
Lesser of total credit or tax on TTA income	\$4,700

**Second limitation:**

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

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Lesser of tax on TTA income or " <i>net tax</i> "/" <i>tax</i> "	\$4,000
Maximum credit allowed:	
Lesser of <i>TTA tax limitation</i> or " <i>net tax</i> "/" <i>tax</i> " <i>limitation</i>	<u>\$4,000</u>
Total TTA credit	\$4,900
Maximum credit allowed	<u>\$4,000</u>
Carryover	\$ 900

In the event that a credit carryover is allowable for any income or taxable year after the TTA designation has expired, has been revoked, is no longer binding, or has become inoperative, the TTA will be deemed to remain in existence for the purpose of computing the business income limitation.

### L. CREDIT WILL NOT REDUCE CERTAIN TAXES

The TTA sales or use tax credit cannot reduce the:

- minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- built-in gains tax (S corporations);
- excess net passive income tax (S corporation); or
- alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries).

The TTA sales or use tax credit may however reduce regular tax below tentative minimum tax.

### M. DEPRECIATION

**References 17053.33(f); 23633(f); 18036; 17267.6(f); 24356.6(e); 24916**

Taxpayers electing to utilize the sales or use tax credit are not entitled to increase the basis of the property for which sales or use tax was paid or incurred in connection with the purchase of the property.

Depreciation of the capitalized cost of the asset may be claimed using any method of depreciation allowable beginning in the year the asset is placed in service.

**NOTE:** If the business expense deduction is taken for the same property, depreciation will start with the income or taxable year following the year in which the property is placed in service. The depreciation is calculated on the remaining

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.



## CALIFORNIA FRANCHISE TAX BOARD

basis *after* reduction for the sales or use tax credit and business expense deduction amounts.

### **N. CREDIT RECAPTURE**

There are no recapture provisions for the TTA sales or use tax credit.

### **O. RECORD KEEPING REQUIREMENTS**

To support the sales or use tax credit claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- the property purchased (such as serial numbers, etc.);
- the amount of sales or use tax paid or incurred upon purchase;
- the location where the property is used; and
- if purchased from a manufacturer located outside California, records to substantiate that property of comparable quality and price was not available for purchase in California.

## **CHAPTER 10      TARGETED TAX AREA BUSINESS EXPENSE DEDUCTION**

### **A.      INTRODUCTION**

***References 17267.6(a); 24356.6(a)***

For each income or taxable year beginning on or after January 1, 1998, a person or entity engaged in a trade or business within a Targeted Tax Area (TTA) may elect to treat 40% of the eligible cost of qualified property as a business expense rather than a capital expense.

The deduction shall be allowed for the income or taxable year in which the property is placed in service.

#### ***TTA Locations and Designation Date***

For a listing of TTA cities, refer to Chapter 1, Section (g). To verify an address, refer to Chapter 1, Section (c).

### **B.      QUALIFIED TAXPAYER**

***References 17267.6(e)(1)(B); 24356.6(d)(1)(B)***

A qualified taxpayer is a person or entity that is engaged in a trade or business within the TTA and whose trade or business is described in the following Standard Industrial Classification (SIC) Manual (1987 edition) code sections:

- Codes 2000 through 2099
- Codes 2200 through 3999
- Codes 4200 through 4299
- Codes 4500 through 4599
- Codes 4700 through 5199

#### ***Pass-Through Entities***

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

#### ***Estates and Trusts***

***References 17267.6(d)(4)***

Estates and trusts are not allowed to take the business expense deduction.

**C. QUALIFIED PROPERTY**

***References 17267.6(d)(1); 24356.6(c)(1)***

Qualified property is IRC Section 1245 property (as defined in section 1245(a)(3) of the Internal Revenue Code) purchased and placed in service for exclusive use in a trade or business conducted within the TTA. The property must also be purchased and placed in service before the date the TTA designation expires, is revoked, is no longer binding, or becomes inoperative.

Qualified property under IRC Section 1245 includes, but is not limited to, tangible personal property (excluding buildings and inventory) that is subject to the allowance for depreciation. This includes most equipment and furnishings purchased for exclusive use within the TTA. Office supplies and other small non-depreciable items are not included.

***Leased Property***

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

**D. PROPERTY NOT QUALIFIED**

***References 17267.6(d)(1); 17267.6(d)(2); 17267.6(d)(5); 24356.6(c)(1); 24356.6(c)(2); 24356.6(c)(4)***

The business expense deduction will not be allowed if the property:

- was transferred between members of an affiliated group;
- was acquired as a gift or inherited;
- was traded for other property;
- was received from a personal or business relation as defined by IRC Section 267, as modified by 17267.6(d)(2)(A) and 24356.6(c)(2)(A) for the TTA;
- was received from a personal or business relation as defined by IRC Section 707(b); or
- is described in IRC Section 168(f).

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 108 of 307

### E. DEDUCTION AMOUNT

**References 17267.6(g); 24356.6(f)**

The maximum *deduction* the taxpayer may claim in any income or taxable year is determined by the number of years that have elapsed since the area was designated, as follows:

Income or Taxable Years	Maximum Aggregate Cost	Maximum Deduction
Income or taxable year of designation and 1st year thereafter	\$100,000	\$40,000
2nd and 3rd income or taxable year thereafter	\$75,000	\$30,000
Each income or taxable year thereafter	\$50,000	\$20,000

### **Partnerships**

**References 17267.6(d)(6)**

In the case of a partnership, the percentage limitation (40%) of the aggregate cost of all qualified property, shall apply at the partnership level and at the partner level.

### **Personal Income Tax Taxpayers-Married Filing Separate**

**References 17267.6(b)**

In the case of a husband and wife filing separate returns for a taxable year, the applicable deduction shall be equal to one-half (50%) of the otherwise allowable deduction.

### F. BASIS REDUCTION

The basis of the asset is to be reduced by the amount of the expense deduction claimed.

### G. INTERACTION WITH THE MANUFACTURER'S INVESTMENT CREDIT

**References 17053.49(b)(1)(C); 23649(b)(1)(C)**

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

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## CALIFORNIA FRANCHISE TAX BOARD

### H. ELECTION

**References 17267.6(a); 17267.6(c); 24356.6(a); 24356.6(b)**

The taxpayer must make an election to treat the cost of qualified property as a business expense on the original return filed for the income or taxable year the property is first placed in service. The election must specify the items to which the election applies and the portion of the cost taken into account for purposes of determining the deduction amount.

The election may not be revoked, unless the taxpayer has obtained the consent of the Franchise Tax Board.

#### ***Making the Election***

The election can be made by using:

- [Form FTB 3809](#) – Targeted Tax Area Deduction and Credit Summary.

#### ***Members of an Affiliated Group***

**References 24356.6(c)(5)-(6)**

For purposes of electing the business expense deduction, all members of an affiliated group shall be treated as one taxpayer. The maximum deduction amount shall be properly apportioned among the members of the affiliated group.

An affiliated group is defined in IRC 1504 as modified by the California Revenue & Taxation Code, to replace "at least 80%" with "more than 50%" each place it appears in IRC 1504(a).

### I. DEPRECIATION

The basis (cost for depreciation purposes) of the property must be reduced by the amount allowed as a deduction. Depreciation of the cost of the property, less the amount deducted, may be claimed using any method of depreciation normally allowed, beginning with the income or taxable year following the year in which the property is placed in service.

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation (IRC Section 179) for the same property.

### J. CREATING A NET OPERATING LOSS

Unlike IRC Section 179, there is *no* statutory prohibition on the amount of business expense deduction that may create a net operating loss.

## CALIFORNIA FRANCHISE TAX BOARD

### K. ALTERNATIVE MINIMUM TAX

**References 17062; 23457**

The business expense deduction is *not* listed as a tax preference item.

### L. RECAPTURE

**References 17267.6(h); 24356.6(g)**

The business expense deduction is subject to recapture (added back to income) if, before the *close of the second income or taxable year after* the property is placed in service, the property is sold, disposed of or is no longer used exclusively within the TTA trade or business.

To recapture the amount deducted, add to the current year income, the amount previously deducted for that property.

**Example:** Corp. A purchases property on June 1, 1998 which qualifies Corp. A to take the TTA business expense deduction. Corp. A's income year ends December 31 of each year. Corp. A disposes of the property August 5, 2000. The previous deduction is added to income in the 2000 tax year because the property was disposed of before the close of the second income or taxable year after the property was placed in service, 12/31/2000.

### M. CHECKLIST TO DETERMINE ELIGIBILITY FOR THE BUSINESS EXPENSE DEDUCTION

Checklist Items	Yes	No
Is the business qualified? <ul style="list-style-type: none"><li>Does the business meet the applicable code section classification as described in the Standard Industrial Classification (SIC) Manual (1987 edition)? See the <i>Qualified Taxpayer</i> section.</li></ul>		
Is the property qualified? <ul style="list-style-type: none"><li>Qualified property is Section 1245 property. See the <i>Qualified Property</i> section.</li><li>Is the property used exclusively within the boundaries of the TTA?</li></ul>		
Is the correct deduction amount claimed? <ul style="list-style-type: none"><li>Limitation differs based on year of designation. See <i>Deduction Amount</i> section.</li></ul>		

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## CALIFORNIA FRANCHISE TAX BOARD

<ul style="list-style-type: none"><li>• Verify purchase on invoices or receipts.</li><li>• Verify the date the property is placed in service.</li></ul>		
Was a timely election made? <ul style="list-style-type: none"><li>• Election made on original return?</li><li>• Form FTB 3809 – Targeted Tax Area Deduction and Credit Summary, or a separate statement attached to the return?</li></ul>		
Was the property acquired through a valid transaction? <ul style="list-style-type: none"><li>• See the <i>Property Not Qualified</i> section.</li></ul>		
Was correct depreciation claimed? <ul style="list-style-type: none"><li>• Basis must be reduced by the amount of the business expense deduction before depreciation is computed.</li><li>• IRC Section 179 expense or additional first year depreciation may not be claimed for qualified property for which the business expense deduction is claimed.</li><li>• A depreciation deduction on qualified property is not allowed in the same year the business expense deduction is claimed.</li></ul>		
Is the deduction subject to recapture? <ul style="list-style-type: none"><li>• Was the property sold, disposed of or no longer used by the taxpayer in the area, before the close of the second income or taxable year after the property was placed in service?</li><li>• Check current location of the qualified property.</li><li>• Check sale or disposal date of qualified property.</li></ul>		

### N. RECORD KEEPING REQUIREMENTS

To support the business expense deduction claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- the property purchased (such as serial numbers, etc.); and
- the location where the property is used

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**CHAPTER 11      TARGETED TAX AREA NET OPERATING LOSS****A.      INTRODUCTION*****References 17276.1(a); 17276.6(a); 24416.1(a); 24416.6(a)***

Taxpayers are required to annually report their income and expenses. Due to possible fluctuations in income and expenses, a taxpayer may have substantial profits in one year, while losses in another. In years where expenses exceed income, a net operating loss (NOL) occurs.

A qualified taxpayer engaged in a trade or business within the designated Targeted Tax Area (TTA) may elect to carry forward 100% of its NOLs for a 15 year period.

A TTA NOL cannot be generated until the first taxable or income year beginning on or after the official TTA designation date (November 1, 1998).

***TTA Locations and Designation Date***

For a listing of TTA cities, refer to Chapter 1, Section (g). To verify an address, refer to Chapter 1, Section (c).

**B.      QUALIFIED TAXPAYER*****References 17276.6(a)(1)-(2); 24416.6(a)(1)-(2)***

For purposes of the TTA NOL deduction, a qualified taxpayer includes a person or entity that is engaged in a trade or business within the TTA, and is described in the following Standard Industrial Classification (SIC) Manual (1987 edition) code sections:

- Codes 2000 through 2099
- Codes 2200 through 3999
- Codes 4200 through 4299
- Codes 4500 through 4599
- Codes 4700 through 5199

Taxpayers doing business in an area that was previously *not* a qualified area, but later designated as qualified, are allowed to utilize the special tax incentives for the taxable or income year beginning on or after the date the area receives its TTA designation.



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 113 of 307

### ***Pass-Through Entities***

#### ***References 17276.6(a)(2); 24416.6(a)(2)***

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

### **C. ELECTION**

#### ***References 17276.1(b); 17276.6(c); 24416.1(c); 24416.6(c)***

Qualified taxpayers must make an election to claim the TTA NOL. The election must be timely filed with the original return, and be for the income or taxable year in which the NOL is incurred. The election is irrevocable.

If the taxpayer is eligible to qualify for an NOL under more than one section (operation in more than one economic development area, new small business etc.), the taxpayer must choose which section to elect. Except for the loss incurred under the subdivision elected, taxpayers are prohibited from carrying over any other type of NOL from the same tax year.

Failure to elect to compute the NOL deduction under section 17276.1 or 24416.1 will cause the NOL to be subject to the limitations and restrictions under section 17276 or 24416 (general NOL).

#### ***Making the Election***

The election can be made by using:

- [Form FTB 3809](#) – Targeted Tax Area Deduction and Credit Summary.

In addition, the form FTB 3809 must be filed for each year in which the NOL deduction is taken.

### **D. TTA NOL COMPUTATION - GENERAL PROVISIONS**

#### ***References 17276.1; 17276.6(b)(2); 24416.1; 24416.6(b)(2)***

A TTA NOL is the loss attributable to the qualified taxpayer's business activities within the TTA, prior to the TTA expiration date. TTA NOLs are determined under IRC Section 172, as modified by California Revenue & Taxation Code Sections 17276.1, 17276.6, 24416.1, and 24416.6

### **E. TTA NOL - LOSS ATTRIBUTED TO BUSINESS ACTIVITY**

#### ***References 17276.6(b)(2); 24416.6(b)(2)***

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## CALIFORNIA FRANCHISE TAX BOARD

A TTA NOL is the loss attributable to the qualified taxpayer's business activities within the TTA prior to the TTA expiration date. Non-business income and/or loss are excluded from the calculation of the TTA NOL.

If a business is located within and outside of the TTA, the taxpayer must determine the portion of the total business loss that is attributable to the TTA.

- Business loss is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxpayers conducting business operations within and without a TTA, business loss is apportioned to the TTA by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

### (i) Property Factor – Loss Apportionment

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the TTA* during the income or taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

### (ii) Payroll Factor – Loss Apportionment

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the TTA during the income or taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

**Example** - Two-factor apportionment: For the income year ending 12/31/99, Corp. A operates within and outside a TTA. Corp. A's business loss of \$13,000

**CALIFORNIA FRANCHISE TAX BOARD**

needs to be apportioned to the TTA. The following amounts apply to Corp. A's property and payroll:

TTA Property	\$40,000
Worldwide (WW) Property	\$100,000
TTA Payroll	\$5,000
WW Payroll	\$10,000

TTA Property/WW Property	=.40	
TTA Payroll/WW Payroll	= <u>.50</u>	
	.90/2 = .45	TTA Apportionment Factor

Business loss	\$(13,000)
Apportionment Factor	<u>x 0.45</u>
TTA NOL	\$(5,850)

**(iii) Apportionment – Combined Groups**

For members of a combined group, the TTA NOL calculation will be based on the combined groups worldwide business loss (before CA apportionment). The numerator of the apportionment formula will be based on each TTA taxpayer's separate TTA payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

**Example:** For the income year ending 12/31/99, Parent corporation A has two subsidiaries, B and C. Corporations A and B operate within an TTA. The combined group operates within and outside California and apportions its income or loss to California using Schedule R. The combined group's business loss is \$1,000,000.

Business loss apportioned to the TTA was determined as follows:

	A	B	C	Combined
Property Factor				
TTA Property	\$2,000,000	\$1,000,000	\$0	\$3,000,000
Worldwide Property				\$5,000,000
Apportionment %	40%	20%		60%
Payroll Factor				
TTA Payroll	\$2,000,000	\$800,000	\$0	\$2,800,000
Worldwide Payroll				\$4,000,000
Apportionment %	50%	20%		70%

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 116 of 307

---

Average Apport. % (Property + Payroll Factors)/2	45%	20%	65%
Business Loss			\$(1,000,000)
TTA NOL	\$(450,000)	\$(200,000)	\$(650,000)

### (iv) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an TTA and one outside the TTA. Eighty percent (80%) of the S corporation's business is attributable to the TTA. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3809 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the TTA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary Loss	200,000
TTA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The TTA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's TTA loss is computed as follows:

Ray's TTA salary (\$100,000 x 50%)	\$50,000
Mary's TTA salary (\$75,000 x 100%)	75,000
Pass-through ordinary loss from the S-Corp.	(160,000)

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## CALIFORNIA FRANCHISE TAX BOARD

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(\$200,000 x 80%)	
TTA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	<u>(1,000)</u>
Total TTA loss	<u>\$(41,000)</u>

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of TTA NOL since they are not related to trade or business activities.

### F. TTA NOL LIMITED BY GENERAL NOL

**References 17276; 24416**

The TTA NOL, as computed under Section (e), is compared to the NOL computed under the general NOL provisions of section 17276 / 24416, prior to the 50% reduction. The TTA NOL carryover is limited to the lesser of the TTA NOL or the general NOL (prior to the 50% reduction). NOTE: If the TTA NOL is limited by the general NOL amount, (prior to the 50% reduction), the amount can still be characterized as an TTA NOL and allowed to be carried over at 100% for 15 years. An election must be made to characterize the NOL as an TTA NOL.

**Example:** Corp. B incurred the following loss:

Income from business operations	\$160,000
Interest from investment which is unrelated to Corp. B's business operations	15,000
Expenses of business operations	<u>(189,000)</u>
<b>Net loss</b>	<b><u>(\$14,000)</u></b>

To determine the NOL carryover attributed to the TTA business operations, the following must be done:

1. Determine NOL per CRTC 24416 (prior to 50% reduction)
2. Determine NOL per CRTC 24416.6 (remove non-business items)

The NOL carryover is limited to the lesser of item 1 or item 2 above.

CRTC 24416 "general" NOL - prior to 50% reduction

Net loss of Corp. B (\$14,000)

CRTC 24416.6 TTA NOL - exclude non-business income/loss

Income from operations \$160,000

Expenses of operations (189,000)

Net loss of Corp. B (TTA) (\$29,000)

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## CALIFORNIA FRANCHISE TAX BOARD

Pattern 1: Assume Corp. B operates entirely within the TTA. Corp. B is allowed to carry over the lesser of the "general" NOL, or the TTA NOL; in this case \$14,000.

Pattern 2: Assume Corp. B conducts 40% of its total business operations in the TTA, as computed under Section (e). Because Corp. B only has 40% of its business operation in the TTA, the \$29,000 business loss must be apportioned before comparing it to the "general" NOL. In this example, the TTA loss is \$11,600 (\$29,000 x 40%). Corp. B is allowed to carry over the lesser of the "general" NOL, or the TTA NOL; in this case, \$11,600.

### **G. CARRYOVER / CARRYBACK**

**References 17276.1(a); 17276.6(b)(1) – (2); 17276.6(e); 24416.1(a); 24416.1(a)(3); 24416.6(b)(1) - (2); 24416.6(f)**

For each income or taxable year beginning on or after January 1, 1998, a qualified taxpayer engaged in a trade or business within the designated TTA may elect to carryover 100% of its NOL. No NOL carrybacks are allowed.

The NOLs may be carried over to each of the 15 income or taxable years following the year of loss, or until exhausted, whichever occurs first. If an NOL carryover remains after the TTA designation has expired, the TTA shall be deemed to remain in existence for purposes of computing the TTA income limitation, and for purposes of allowing the TTA NOL deduction.

**NOTE:** Financial institutions. As defined in IRC Sections 585, 586, or 593, using bad debt reserve methods may carry the loss forward for a maximum of 5 income years.

### **H. TTA NOL DEDUCTION - GENERAL PROVISIONS**

**References 17276.6(b)(3); 17276.6(b)(4); 24416.6(b)(3); 24416.6(b)(4)**

The TTA NOL carryover can only offset business income attributable to operations of the taxpayer within the designated TTA.

In the event that a TTA NOL carryover is allowable for any taxable or income year after the TTA designation has expired, has been revoked, is no longer binding, or has become inoperative, the TTA will be deemed to remain in existence for the purpose of computing the business income limitation and allowing a TTA NOL deduction.

**(i.) Income Attributed to Business Activity****References 17276.6(b)(4); 17276.6(b)(4)(A); 24416.6(b)(4); 24416.6(b)(4)(A)**

If a business is located within and outside of the TTA, the taxpayer must determine the portion of the total business income that is attributable to the TTA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

Business income shall be apportioned to the TTA by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

**(ii) Property Factor – Income Apportionment**

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the TTA* during the income or taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

**(iii) Payroll Factor – Income Apportionment**

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the TTA during the income or taxable year.
- The denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.

**Example:** Corp. A operates within and outside the TTA. California business income of \$13,000 needs to be apportioned to the TTA. The following amounts apply to Corp. A's property and payroll:

**CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 120 of 307

TTA Property	\$40,000
CA Property	\$100,000
TTA Payroll	\$5,000
CA Payroll	\$10,000

$$\begin{aligned} \text{TTA Property/CA Property} &= .40 \\ \text{TTA Payroll/CA Payroll} &= .50 \\ .90/2 &= .45 \quad \text{TTA Apportionment Factor} \end{aligned}$$

Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
TTA Business Income	\$5,850

**(iv) Apportionment – Combined Groups**

For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the TTA. The numerator of the apportionment formula will be based on each TTA taxpayer's separate TTA property and payroll amounts and the denominator will be based on each TTA taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the TTA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate TTA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the TTA was determined as follows:

	A	B
<u>Property Factor</u>		
TTA Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
TTA Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%

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**CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 121 of 307

---

Average Apport. %	100%	73.33%
(Property + Payroll Factors)/2		
Apportioned Business Income	\$228,000	\$250,000
TTA Income	\$228,000	\$183,333

**(v) Apportioning for Personal Income Tax Taxpayers**

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an TTA and one outside the TTA. Eighty percent (80%) of the S corporation's business is attributable to the TTA. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3809 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the TTA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
TTA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The TTA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's TTA income is computed as follows:

Ray's TTA salary (\$100,000 x 50%)	\$50,000
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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 122 of 307

---

Mary's TTA salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. (\$40,000 x 80%)	32,000
TTA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	<u>(1,000)</u>
Total TTA income	\$151,000

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of TTA income since they are not related to trade or business activities.

### I. S CORPORATIONS

**References 23802(d)(1)-(2)**

For qualified taxpayers electing S corporation status *after* the designation of the TTA, the qualified NOL attributed to the C corporation years cannot offset S corporation net income.

### J. ALTERNATIVE MINIMUM TAX

**References 17062; 23456**

Taxpayers claiming a TTA NOL deduction must also determine their NOL for alternative minimum tax purposes.

### K. FLOW-THROUGH LOSSES

**References 17087.5; 17087.6; 17851; 23800; 24271**

The income and loss that will flow through to a shareholder, beneficiary, partner, or member, retains the same characteristics as it had with the pass-through entity.

The election (Section C) to claim an NOL must be made by the entity and each investor on their respective returns. The election by the entity to utilize the TTA NOL does not extend to, or bind the investor to utilizing the TTA NOL. Further, the investor may utilize the TTA NOL if the entity utilized the general NOL provisions, or had no NOL. Each taxpayer must determine if they in fact have a NOL, and then decide whether the general or TTA NOL will be utilized.

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**CHAPTER 12      LOCAL AGENCY MILITARY BASE RECOVERY AREA  
HIRING CREDIT****A.      INTRODUCTION*****References 17053.46(a); 17053.46(b)(4)(B); 23646(a); 23646(b)(4)(B)***

For each income or taxable year beginning on or after January 1, 1995, the California Revenue and Taxation Code (CRTC) provides a hiring credit for "qualified taxpayers" who operate or invest in a business located within a designated Local Agency Military Base Recovery Area (LAMBRA) and hire "qualified employees" and pay them "qualified wages". LAMBRA's were established in California to stimulate development in areas that experience military base closures.

The LAMBRA hiring credit applies to those employees hired after the designation date of the LAMBRA.

**NOTE:** The first LAMBRA was designated on February 1, 1996.

***LAMBRA Locations and Designation Dates***

For a listing of LAMBRA's, refer to Chapter 1, Section (e). To verify an address, refer to Chapter 1, Section (c).

**B.      QUALIFIED TAXPAYER*****References 17053.46(b)(5); 23646(b)(5)***

A "qualified taxpayer" is any taxpayer engaged in a trade or business within a LAMBRA and, within the first two income or taxable years of commencing business within the LAMBRA, has a net increase in jobs (defined as 2,000 paid hours per employee per year) of one or more employees in the LAMBRA.

***Allowance of the LAMBRA Hiring Credit******References 17053.46(a); 17053.46(d)(4); 23646(a); 23646(d)(4)***

Taxpayers engaged in operations within a LAMBRA are allowed to utilize the LAMBRA hiring credit beginning in the first year of operations within the LAMBRA even though they cannot fulfill the definition of a qualified taxpayer before the close of the second year of operations in the LAMBRA when the net increase in jobs is computed. If at the end of the second year the taxpayer does not meet the definition of a "qualified taxpayer", the LAMBRA hiring credit previously utilized needs to be recaptured.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 124 of 307

### ***Pass-Through Entities***

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The hiring credit is allowed to the pass-through entity and passed through to the partners or shareholders.

### ***Controlled Groups***

**References 17053.46(c)(1)(A); 17053.46(c)(1)(B); 23646(c)(1)(A); 23646(c)(2)**

All employees of trades or businesses that are under common control, or members of the same controlled group of corporations, shall be treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC 1563(a) as modified by the California Revenue & Taxation Code, to replace "at least 80%" with "more than 50%". The determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of IRC Section 1563.

**NOTE:** Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

### ***Acquired Businesses***

**References 17053.46(c)(2); 23646(c)(3)**

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues to be employed in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues to be employed in that business.

**NOTE:** The new employer, "*steps into the shoes*" of the old employer for purposes of incurring future credits.

## **C. QUALIFIED WAGES**

**References 17053.46(b)(1); 17053.46(b)(2); 17053.46(e); 23646(b)(1); 23646(b)(2)**

*Qualified wages* are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer. For qualified employees hired before the expiration date of the LAMBRA, qualified wages paid or incurred within the 60-month period beginning with the first day the employee commences employment with the taxpayer shall continue to qualify for the credit after the

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## CALIFORNIA FRANCHISE TAX BOARD

area expiration date, as if the LAMBRA designation were still in existence and binding.

Qualified *wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

### ***Annual Wage Limitation***

The total amount of qualified wages that may be taken into account for purposes of claiming the credit shall not exceed two million dollars (\$2,000,000) each income or taxable year.

### ***Estates and Trusts***

In the case of an estate or trust, the qualified wages shall be apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages have been apportioned, shall be treated as the employer with respect to those wages.

### ***Non-Qualified Wages***

Qualified wages *do not* include any wages paid or incurred on or after the area expiration date except as noted previously for qualified employees hired prior to the expiration of the LAMBRA.

### ***Minimum Wage Chart***

Effective Date	Minimum Wage	Maximum Wage (150% of Minimum Wage)
Prior to October 1, 1996	\$4.25	\$6.37
October 1, 1996, through February 28, 1997	\$4.75	\$7.12
March 1, 1997 through August 31, 1997	\$5.00	\$7.50
September 1, 1997 through February 28, 1998	\$5.15	\$7.72
March 1, 1998 to Current	\$5.75	\$8.62

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 126 of 307

### D. QUALIFIED EMPLOYEE

**References 17053.46(b)(4); 17053.46(b)(6); 23646(b)(4); 23646(b)(6)**

A *qualified employee* can be either a “qualified disadvantaged individual” or a “qualified displaced employee”.

A “qualified disadvantaged individual” is an individual who satisfies all of the following:

#### **ANNUAL TESTS**

- At least 90% of the individual’s services for the taxpayer, during the income or taxable year, must be directly related to the conduct of the taxpayer’s trade or business located within the LAMBRA;
- At least 50% of the individual’s services for the taxpayer, during the income or taxable year, must be performed within the boundaries of the LAMBRA;

#### **TIME OF HIRE TESTS**

- The individual is hired after the area was designated as a LAMBRA; and
- Immediately prior to starting work for the taxpayer, the individual is any of the following:

***For taxable or income years beginning on or after January 1, 1999:***

1. Eligible for services under the federal Job Training Partnership Act (JTPA);
2. Eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) Act of 1985;
3. An economically disadvantaged individual 16 years of age or older;
4. A qualified dislocated worker (refer to the CRTC or the 3807 Business Booklet for an expanded definition);
5. Enrolled in or has completed a state rehabilitation plan;
6. A service-connected disabled veteran;
7. A veteran of the Vietnam era;
8. A veteran who recently separated from military service;
9. An ex-offender;
10. A person who is a recipient of;
  - Federal Supplemental Security Income (SSI) benefits;
  - Aid to Families with Dependent Children (AFDC);
  - Food stamps; or
  - State and local general assistance;
11. A Native American.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 127 of 307

***For taxable or income years beginning on or after January 1, 1995, and before January 1, 1999:***

4. Eligible for services under the federal Job Training Partnership Act (JTPA), or its successor;
5. Eligible to be a voluntary or mandatory registrant under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor;
6. Eligible, as determined by EDD, under the federal Targeted Jobs Tax Credit Program, whether or not this program is in effect

A "qualified displaced employee" is an individual who satisfied all of the following:

### **ANNUAL TESTS**

- At least 90% of the individual's work for the taxpayer, during the income or taxable year, must be directly related to the conduct of the taxpayer's trade or business located within the LAMRBA;
- At least 50% of the individual's services for the taxpayer, during the income or taxable year, must be performed within the boundaries of the LAMBRA;

### **TIME OF HIRE TESTS**

- The individual is hired after the LAMBRA was designated as a LAMBRA; and
- The employee is a civilian or military employee of a base or former base who has been displaced as a result of a federal base closure act.

### ***Seasonal Employees***

***References 17053.46(b)(1)(C); 17053.46(b)(7); 23646(b)(1)(C); 23646(b)(7)***

"Seasonal employment" means employment that has regular and predictable substantial reductions in business operations.

Reemployment of an individual, in connection with any increase (including a regularly occurring seasonal increase) in business operations, does not constitute commencement of employment for purposes of the LAMBRA hiring credit.

### ***Leased Employees***

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer can be identified due to the legal obligation to pay the payroll taxes of the employee, and as to who has the right to control and direct the workers (employee's) services.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Revenue Service (IRS) Publication 15-A, *Employer's Supplemental Tax Guide* provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship.

### E. CREDIT COMPUTATION

**References 17053.46(a); 17053.46(b)(1)(B); 23646(a); 23646(b)(1)(B)**

For each income or taxable year beginning on or after January 1, 1995, a hiring credit shall be allowed to a qualified taxpayer for hiring a qualified employee for employment within a LAMBRA. The credit shall be equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The total amount of qualified wages used to compute the LAMBRA hiring credit cannot exceed \$2,000,000 per each income or taxable year.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit will be used.

**Example:** An employee was hired 7/1/1998, and the taxpayer is completing the tax return for the year ending 12/31/1999. For the period 1/1/1999 to 6/30/1999, the hiring credit is based on 50% of qualified wages. For the period 7/1/1999 to 12/31/1999, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

**Example:** An employee is hired 7/1/1998, is temporarily laid off 2/1/1999, and is rehired 4/1/1999. The 50% credit range runs from 7/1/1998 to 6/30/1999 regardless of the layoff period between 2/1/1999 and 3/31/1999.



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 129 of 307

### ***Credit Adjustments and Limitations***

#### ***References 17053.46(i); 23646(i)***

In the case where an employee qualifies the taxpayer to take more than one wage credit, the taxpayer may claim only one credit for the same wage expense.

### ***Reduction for Other Tax Credits***

#### ***References 17053.46(f); 23646(f)***

The LAMBRA hiring credit shall be reduced by the credit allowed under CRTC Sections 17053.7 and 23621 (Jobs Tax Credit), and the federal credit allowed under IRC Section 51 (Work Opportunity Tax Credit – WOTC).

## **F. WAGE EXPENSE DEDUCTION**

### ***References 17053.46(f); 23646(f)***

The taxpayer must reduce any deduction for wages by the amount of the LAMBRA hiring credit allowed (includes any current year credit to be carried forward).

## **G. BUSINESS INCOME ACTIVITY LIMITATION**

### ***References 17053.46(h); 23646(h)***

The amount of the hiring credit or the sales or use tax credit (see Chapter 13) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's LAMBRA business income in any year. Depending on the tax year involved, the LAMBRA business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the LAMBRA. Non-business income or loss is not included in the calculation of business income from the LAMBRA. Each taxpayer claiming the credit must compute the LAMBRA business income and resulting tax.

Example: Corp. A operates entirely within a LAMBRA. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	\$2,000
Business expenses	<u>(17,000)</u>
Net Taxable Income	\$15,000

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 130 of 307

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	<u>(17,000)</u>
Net Business Income	\$13,000

To determine the LAMBRA hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	\$13,000
x 8.84%	<u>x .0884</u>
Tax associated with business income	\$1,149

In this example, the taxpayer can offset the tax of \$1,149 with the LAMBRA hiring credit available (up to \$1,149).

NOTE: "tax"/"net tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

### **H. GENERAL PROVISIONS – APPORTIONMENT OF BUSINESS INCOME** ***References 17053.46(h)(2); 17053.46(h)(3); 23646(h)(2); 23646(h)(3)***

If a business is located within and outside of a LAMBRA, or in more than one LAMBRA, the taxpayer must determine the portion of the total business income that is attributable to the LAMBRA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1995, and before January 1, 1998, business income is apportioned to the LAMBRA by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning on or after January 1, 1998, business income shall be apportioned to the LAMBRA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

#### **(i) Property Factor – Income Apportionment**

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 131 of 307

used or available for use by the taxpayer *within the LAMBRA* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1995, and before January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.
- For income or taxable years beginning on or after January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

### (ii) Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the LAMBRA* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1995, and before January 1, 1998, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.
- For income or taxable years beginning on or after January 1, 1998, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.

**Example:** For the income year ending 12/31/99, Corp. A operates within and outside a LAMBRA. Total business income of \$13,000 needs to be apportioned to the LAMBRA. The following amounts apply to Corp. A's property and payroll:

LAMBRA Property	\$40,000	
CA Property for Corp. A	\$100,000	
LAMBRA Payroll	\$5,000	
CA Payroll for Corp. A	\$10,000	
LAMBRA Property/CA Property	= .40	
LAMBRA Payroll/CA Payroll	= <u>.50</u>	
	.90/2 = .45	LAMBRA Apportionment Factor
Business income	\$13,000	
Apportionment Factor	<u>x 0.45</u>	

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 132 of 307

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LAMBRA Business Income	\$5,850
Current Tax Rate	<u>x .0884</u>
Tax attributable to LAMBRA business income	\$517

For an example of apportionment rules pre-1998, refer to Chapter 23, Section (g).

### (iii) Apportionment – Combined Groups

For income or taxable years beginning on or after January 1, 1995, and before January 1, 1998: For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each LAMBRA taxpayer's separate LAMBRA payroll and property amounts and the denominator will be based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to Chapter 23, Section (g)(iv).

For income or taxable years beginning on or after 1/1/1998: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the LAMBRA. The numerator of the apportionment formula will be based on each LAMBRA taxpayer's separate LAMBRA property and payroll factor amounts and the denominator will be based on each LAMBRA taxpayer's separate California property and payroll factor amounts.

**Example:** For the income year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within a LAMBRA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate LAMBRA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LAMBRA was determined as follows:

	A	B
<u>Property Factor</u>		
LAMBRA Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 133 of 307

### Payroll Factor

LAMBRA Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%

Average Apport. %	100%	73.33%
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(Property + Payroll  
Factors)/2

### Apportioned

Business Income	\$228,000	\$250,000
LAMBRA Income	\$228,000	\$183,333

### (iv) **Apportioning for Personal Income Tax Taxpayers**

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within a LAMBRA and one outside the LAMBRA. Eighty percent (80%) of the S corporation's business is attributable to the LAMBRA. (**NOTE:** This percentage was determined by the S corporation, using Worksheet IV from the FTB 3807 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the LAMBRA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
LAMBRA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 134 of 307

\*The LAMBRA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LAMBRA income is computed as follows:

Ray's LAMBRA salary (\$100,000 x 50%)	\$50,000
Mary's LAMBRA salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. (\$40,000 x 80%)	32,000
LAMBRA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	(1,000)
<b>Total LAMBRA income</b>	<b>\$151,000</b>

Ray and Mary must compute the tax on the total LAMBRA income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status married filing joint; the 1999 tax on \$151,000 is \$10,659. The \$10,659 is the first limitation on LAMBRA credits for the 1999 tax year. The second limitation on the credits is the net tax on all income.

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of LAMBRA income since they are not related to trade or business activities.

### I. S CORPORATIONS

**References 17053.46(f); 23646(f); 23803(a)(1)(A); 23803(a)(1)(F)**

An S corporation's hiring credit may reduce the LAMBRA tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's LAMBRA income.

One hundred percent (100%) of the LAMBRA hiring credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

**Example:** An S corporation computes a \$3,000 hiring credit. The S corporation's credit is \$1,000 and the wage reduction is \$1,000. The \$3,000

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## CALIFORNIA FRANCHISE TAX BOARD

credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is \$3,000.

### J. CREDIT USAGE & CARRYOVER

**References 17053.46(g); 17053.46(h)(1); 17053.46(h)(4); 23646(g); 23646(h)(1); 23646(h)(4)**

The total amount of the LAMBRA hiring credit and sales or use tax credit, including any credit carryover from prior years, that may reduce the "tax"/"net tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the LAMBRA, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the "tax"/"net tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

**Example:** A taxpayer has a \$4,900 LAMBRA hiring credit. Tax imposed on LAMBRA business income is \$4,700, and the taxpayer's overall "net tax" is \$4,000. The taxpayer would be eligible to claim a \$4,000 maximum hiring credit.

Total LAMBRA hiring credit	\$4,900
Tax on LAMBRA income	\$4,700

**First limitation:**

Lesser of total credit or tax on LAMBRA income	\$4,700
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**Second limitation:**

Lesser of tax on LAMBRA income or "net tax"/"tax"	\$4,000
Maximum credit allowed: Lesser of <i>LAMBRA tax limitation</i> or " <i>net tax</i> "/" <i>tax</i> " limitation	<u>\$4,000</u>
Total LAMBRA hiring credit	\$4,900
Maximum credit allowed	<u>\$4,000</u>
Carryover	\$ 900

In the event that a credit carryover is allowable for any income or taxable year after a LAMBRA designation has expired, the area will be deemed to remain in existence for purposes of computing the business income limitation.

### K. CREDIT WILL NOT REDUCE CERTAIN TAXES

The LAMBRA hiring credit cannot reduce the:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation);
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- Regular tax below tentative minimum tax.

### **L. CREDIT RECAPTURE**

**References 17053.46(d)(1)(A); 17053.46(d)(1)(B); 17053.46(d)(3); 23646(d)(1)(A); 23646 (d)(1)(B); 23646 (d)(3)**

#### ***Non-Seasonal Employees***

Except as discussed subsequently, recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods:

- The first 270 "days of employment" (whether or not consecutive); or
- Ninety (90) "days of employment" plus 270 calendar days.

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

#### ***Seasonal Employees***

For income or taxable years beginning on or after January 1, 1998, for seasonal employees, the taxpayer must recapture the amount of the credit if employment is terminated before the completion of 270 "days of employment" during the 60-month period beginning the day the employee commences employment with the taxpayer except as subsequently discussed.

To recapture the credit, the taxpayer must add the amount of credit previously claimed in all years to the tax for the tax year that includes the 60<sup>th</sup> month of employment.

For all employees, a "day of employment" includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

**NOTE:** Any increase in tax, due to credit recapture, cannot be offset by the current year hiring credit.



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 137 of 307

### ***Credit Recapture – Exceptions***

***References 17053.46(d)(2)(A); 17053.46(d)(2)(B); 23646(d)(2)(A); 23646(d)(2)(B)***

For both regular and seasonal employees, the credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business; or
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

### ***Change in the Form of the Trade or Business***

***References 17053.74(e)(2)(C); 23622.7(e)(2)(C)***

The employment relationship between the taxpayer and an employee shall not be treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues to be employed in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee shall not be treated as terminated.

### ***Special LAMBRA Recapture***

***References 17053.45(b)(2); 17053.45(g)(2); 23645(b)(2); 23645(g)(2)***

The taxpayer must have a *net increase of one or more jobs in the LAMBRA* at the close of the second taxable or income year of doing business within a LAMBRA. If there is not a net increase of one or more jobs, the credit previously claimed shall be added to the taxpayer's "net tax"/"tax" for the second taxable or income year.

The net increase in the number of jobs is determined by applying two tests:

The first test requires a taxpayer to subtract the number of full-time employees (defined as 2,000 paid hours per employee per year) employed in this state in the taxable year prior to commencing business operations in the LAMBRA from the total number of full-time employees employed in this state during the second taxable year after commencing business operations in the LAMBRA.

- ♦ For taxpayers that commence doing business in this state with their LAMBRA business operation, the number of employees for the taxable year prior to commencing business operations in the LAMBRA shall be zero.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

If the first test is met, the credit is allowed only if the second test is met which is one or more full-time employees are employed within the LAMBRA.

To determine the first test of the net increase in jobs requirement, the following formula is used:

- The total number of hours worked in this state, by the taxpayer's CA employees (not to exceed 2,000 hours per employee) who are paid an hourly wage, divided by 2,000, plus,
- The total number of months worked in this state, by the taxpayer's CA employees who are salaried employees, divided by 12.

**NOTE:** For taxpayers that first commence doing business in the LAMBRA during the taxable or income year, the divisors "2,000" and "12" shall be multiplied by a fraction, the numerator of which is the number of months of the taxable or income year that the taxpayer was doing business in the LAMBRA and the denominator of which is 12.

To determine the second test of the net increase in jobs requirement, the following formula is used:

- The total number of hours worked in this state, by the taxpayer's LAMBRA employees (not to exceed 2,000 hours per employee) who are paid an hourly wage, divided by 2,000, plus,
- The total number of months worked in this state, by the taxpayer's LAMBRA employees who are salaried employees, divided by 12.

### ***Example:***

A Corporation employs four individuals prior to establishing operations in the LAMBRA on January 1, 1998. The following is the employment information for the employees for the income year prior to operating in the LAMBRA:

- Employee #1: Salaried, employed for 12 months.
- Employee #2: Hourly, full-time; worked 2,080 hours per year.
- Employee #3: Hourly, part-time; worked 1,500 hours per year.
- Employee #4: Hourly, part-time; worked 1,500 hours per year.

The corporation moves its entire operations within the LAMBRA on January 1, 1998. At the end of the first year of operation within the LAMBRA, the corporation employed the following individuals:

## CALIFORNIA FRANCHISE TAX BOARD

- Employee #1: Salaried; employed 24 months.
- Employee #2: Hourly, full-time; worked 2,080 hours during the year.
- Employee #3: Hourly, part-time; worked 2,000 hours during the year.
- Employee #4: Hourly, part-time; worked 1,600 hours during the year.
- Employee #5: Hourly, part-time; worked 1,600 hours during the year.

At the end of the 2nd year of operation in the LAMBRA, the corporation employed the following individuals:

- Employee #1: Salaried; employed 36 months.
- Employee #2: Hourly, full-time; worked 2,080 hours during the year.
- Employee #3: Hourly, part-time; worked 2,000 hours during the year.
- Employee #4: Hourly, part-time; worked 1,700 hours during the year.
- Employee #5: Hourly, part-time; worked 1,900 hours during the year.

***The first test for the net increase in jobs is computed as follows:***

For the taxable or income year beginning prior to 1/1/98, the relocation date to the LAMBRA:

Hourly Employees:

Employee #2	2000 hours
Employee #3	1500 hours
Employee #4	<u>1500</u> hours
Total	5000 hours

Divide by 2000

Total hourly employees                      2.5 employees

Salaried Employees

Employee #1	<u>12</u> months
Total	12 months

Divide by 12

Total Salaried employees                      1.0 employee

Total employees                                      3.5 employees

At the end of the 2nd year of operation in the LAMBRA:

Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 140 of 307

Employee #4	1700 hours
Employee #5	<u>1900</u> hours
Total	7600 hours
Divide by 2000	
Total hourly employees	3.8 employees

Salaried Employees	
Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee
Total employees	4.8 employees

Subtract the total employees employed in the year prior to beginning operations in the LAMBRA from the employees employed at the end of the second year of operations in the LAMBRA

Employees employed at the end of the second Year of operation in the LAMBRA	4.8 employees
Employees employed prior to relocation To the LAMBRA	<u>3.5</u> employees
Total increase	1.3 employees

The first test of the net increase in jobs requirement has been met. The taxpayer has had a net increase of at least 1 employee in the state of CA at the close of the two year period beginning at the time the taxpayer relocated into the LAMBRA.

- If the taxpayer does not have a net increase of one or more employees during this time period, all LAMBRA tax incentives are required to be recaptured.

### ***The second test for the net increase in jobs is computed as follows:***

At the end of the 1st year of operation in the LAMBRA:

#### Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1600 hours
Employee #5	<u>1600</u> hours
Total	7200 hours
Divide by 2000	

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 141 of 307

---

Total hourly employees                      3.6 employees

### Salaried Employees

Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees at the end of the 1st year  
of operation in the LAMBRA              4.6 employees

### At the end of the 2nd year of operation in the LAMBRA:

#### Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1700 hours
Employee #5	<u>1900</u> hours
Total	7600 hours
Divide by 2000	
Total hourly employees	3.8 employees

### Salaried Employees

Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees at the end of the 2nd year  
of operation in the LAMBRA              4.8 employees

The second test of the net increase in jobs requirement has been met. The taxpayer has at least one employee in the LAMBRA in each of the first two years of operations in the LAMBRA.

- If the taxpayer does not have at least one employee in the LAMBRA during these time periods, all LAMBRA tax incentives are required to be recaptured.

## M. RECORD KEEPING REQUIREMENTS

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## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 142 of 307

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For each qualified employee, documentation showing:

- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

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## **CHAPTER 13      LOCAL AGENCY MILITARY BASE RECOVERY AREA (LAMBRA) SALES OR USE TAX CREDIT**

### **A.      INTRODUCTION**

***References 17053.45(a); 17053.45(b)(3)(B); 23645(a); 23645(b)(3)(B)***

For each income or taxable year beginning on or after January 1, 1995, a taxpayer engaged in a trade or business within a designated Local Agency Military Base Recovery Area (LAMBRA) can take a credit for sales or use tax paid or incurred in connection with the purchase of qualified property.

- In any year, individuals may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first \$1 million of qualified property.
- In any year, corporations may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first \$20 million of qualified property. (See special rule for S corporations and shareholders in Section (i).)

No credit may be claimed for property purchased after the LAMBRA designation expires, is no longer binding, or becomes inoperative.

NOTE: The first LAMBRA was designated on February 1, 1996.

### ***LAMBRA Locations and Designation Dates***

*For a listing of LAMBRAs, refer to Chapter 1, Section (e). To verify an address, refer to Chapter 1, Section (c).*

### **B.      EXCLUSIVE CREDIT**

***References 17053.45(h); 23645(h)***

If the LAMBRA sales or use tax credit is claimed for the purchase of qualified property during the income or taxable year, no other credit shall be allowed with respect to that property.

### **C.      "TAXPAYER" DEFINED**

***References 17053.45(b)(2); 23645(b)(2)***

A "taxpayer" is a person or entity engaged in a trade or business within a LAMBRA and, for the first two income or taxable years, has a net increase in jobs (defined as 2,000 paid hours per employee per year) of one or more employees in the LAMBRA.

### ***Allowance of the LAMBRA Sales or Use Tax Credit***

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## CALIFORNIA FRANCHISE TAX BOARD

Taxpayers engaged in operations within a LAMBRA are allowed to utilize the LAMBRA credit beginning in the first year of operations within the LAMBRA even though they cannot fulfill the definition of a qualified taxpayer before the close of the second year of operations in the LAMBRA when the net increase in jobs is computed. If at the end of the second year the taxpayer does not meet the definition of a "qualified taxpayer", the LAMBRA credit previously utilized needs to be recaptured.

### ***Pass-Through Entities***

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The sales or use tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

### **D. QUALIFIED PROPERTY**

***References 17053.45(b)(3); 23645(b)(3)***

Qualified property is property purchased by the taxpayer for exclusive use in the LAMBRA and includes, but is not limited to, the following:

- High technology equipment, such as computers and electronic processing equipment.
- Aircraft maintenance equipment, such as engine stands, hydraulic mules, power carts, test equipment, hand tools, aircraft start carts, and tugs.
- Aircraft components, such as engines, fuel control units, hydraulic pumps, avionics, starts, wheels, and tires.
- Section 1245 property, as defined in Section 1245(a)(3) of the Internal Revenue Code.

### ***Leased Property***

Taxpayers who acquire property by lease arrangement may qualify for the sales or use tax credit. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the sales or use tax credit. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

### **E. CREDIT COMPUTATION – ASSET VALUE LIMITATION**

***References 17053.45(a); 23645(a)***

The sales or use tax credit is equal to the amount of sales or use tax "paid or incurred" by the taxpayer in connection with the purchase and use of qualified property.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.



## CALIFORNIA FRANCHISE TAX BOARD

**Example:** Taxpayer spent \$53,750 to purchase property used in the taxpayer's business within the LAMBRA. The sales tax paid on the purchase is \$3,750. The sales tax credit is \$3,750.

Individuals, estates or trusts, partnerships, and limited liability companies (LLCs) taxed as partnerships may claim a credit on the sales or use tax paid or incurred to purchase up to \$1 million of qualified property. Corporations may claim a credit on the sales or use tax paid or incurred to purchase up to \$20 million of qualified property. This limitation applies to each income or taxable year. (See special rule for S corporations and shareholders in Section (i).)

**NOTE:** Upon acquisition, if the taxpayer/purchaser was exempt from paying sales tax on the property under the California Revenue & Taxation Code (CRTC), then the taxpayer/purchaser did not pay or incur sales tax in connection with the purchase of the property to the extent of the exemption. Thus, the taxpayer/purchaser is not allowed to take the sales or use tax credit for the exemption amount.

### ***Use Tax Paid on Qualified Property***

#### ***References 17053.45(c); 23645(c)***

If a taxpayer, operating within a LAMBRA, purchases property out of state and pays or incurs a use tax, the credit will be allowed only if qualified property of a comparable quality and price is not timely available for purchase in this state.

### **F. DEPRECIABLE BASIS**

#### ***References 17053.45(e); 23645(e)***

Any taxpayer that elects to claim the sales or use tax credit, shall *not* increase the basis of the qualified property by the amount of the sales or use tax paid or incurred.

**Example:** Taxpayer spent \$53,750 to purchase property used in the taxpayer's business within the LAMBRA. The sales tax included in the purchase price was \$3,750. The basis of the property is \$50,000 (\$53,750 less \$3,750 sales tax).

### **G. BUSINESS INCOME ACTIVITY LIMITATION**

#### ***References 17053.45(f)(1); 23645(f)(1)***

The amount of sales or use tax credit and the hiring credit (see Chapter 12) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's LAMBRA business income in any year. Depending on the tax year involved, the LAMBRA business income is that

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 146 of 307

portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the LAMBRA. Non-business income or loss is not included in the calculation of business income from the LAMBRA. Each taxpayer claiming the credit must compute the LAMBRA business income and resulting tax.

**Example:** Corp. A operates exclusively within a LAMBRA. In order to determine the amount of sales or use tax credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	\$2,000
Business expenses	<u>(17,000)</u>
Net Taxable Income	\$15,000

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	<u>(17,000)</u>
Net Business Income	\$13,000

To determine the sales or use tax credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	\$13,000
x 8.84%	<u>x 0.0884</u>
Tax associated with business income	\$1,149

In this example, the taxpayer can offset the tax of \$1,149 with the sales or use tax credit available (up to \$1,149).

**NOTE:** "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

### H. GENERAL PROVISIONS – APPORTIONMENT OF BUSINESS INCOME

**References 17053.45(f)(1); 17053.45(f)(2)(A); 23645(f)(1); 23645(f)(2)(A)**

If a business is located within and outside of a LAMBRA, or in more than one LAMBRA, the taxpayer must determine the portion of the total business income that is attributable to the LAMBRA.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1995, and before January 1, 1998, business income is apportioned to the LAMBRA by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning on or after January 1, 1998, business income shall be apportioned to the LAMBRA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

### (i) Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LAMBRA* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1995, and before January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.
- For income or taxable years beginning on or after January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

### (ii) Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the LAMBRA* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1995, and before January 1, 1998, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 148 of 307

- For income or taxable years beginning on or after January 1, 1998, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.

**Example:** For income year ending 12/31/1998, Corp. A operates within and outside a LAMBRA. Total business income of \$13,000 needs to be apportioned to the LAMBRA. The following amounts apply to Corp. A's property and payroll:

LAMBRA Property	\$40,000
CA Property for Corp. A	\$100,000
LAMBRA Payroll	\$5,000
CA Payroll for Corp. A	\$10,000

LAMBRA Property/CA Property	= .40	
LAMBRA Payroll/CA Payroll	= <u>.50</u>	
	.90/2 = .45	LAMBRA Apportionment Factor

Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
LAMBRA Business Income	\$5,850
Current Tax Rate	<u>x .0884</u>
Tax attributable to LAMBRA business income	\$517

For an example of apportionment rules pre-1998, refer to Chapter 23, Section (g).

### (iii) Apportionment – Combined Groups

For income or taxable years beginning on or after January 1, 1995, and before January 1, 1998: For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each LAMBRA taxpayer's separate LAMBRA payroll and property amounts and the denominator will be based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to Chapter 23, Section (g)(iv).

For income or taxable years beginning on or after 1/1/1998: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the LAMBRA. The numerator of the apportionment formula will be based on each LAMBRA taxpayer's separate LAMBRA property and payroll amounts and the denominator

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 149 of 307

will be based on each LAMBRA taxpayer's separate California property and payroll amounts.

**Example:** For income year ended 12/31/1998, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within a LAMBRA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate LAMBRA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LAMBRA was determined as follows:

	A	B
<u>Property Factor</u>		
LAMBRA Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
 <u>Payroll Factor</u>		
LAMBRA Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
 Average Apport. %	100%	73.33%
(Property + Payroll Factors)/2		
 Apportioned		
Business Income	\$228,000	\$250,000
LAMBRA Income	\$228,000	\$183,333

### (iv) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within a LAMBRA and one outside the LAMBRA. Eighty percent (80%) of the S corporation's business is attributable to the LAMBRA. (**NOTE:** This percentage was determined by the S corporation, using Worksheet IV from the FTB 3807 Business Booklet, at the time the S corporation return was prepared). Ray

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 150 of 307

divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the LAMBRA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
LAMBRA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The LAMBRA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LAMBRA income is computed as follows:

Ray's LAMBRA salary (\$100,000 x 50%)	\$50,000
Mary's LAMBRA salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp.	
(\$40,000 x 80%)	32,000
LAMBRA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	(1,000)
<b>Total LAMBRA income</b>	<b>\$151,000</b>

Ray and Mary must compute the tax on the total LAMBRA income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status married filing joint; the 1999 tax on \$151,000 is \$10,659. The \$10,659 is the first limitation on LAMBRA credits for the 1999 tax year. The second limitation on the credits is the net tax on all income.

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of LAMBRA income since they are not related to trade or business activities.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 151 of 307

### I. S CORPORATION & SHAREHOLDER CREDIT AMOUNTS

**References 17053.45(a); 23645(a); 23803(a)**

S corporations operating within a LAMBRA may claim a credit on the sales or use tax paid or incurred to purchase up to \$20 million of qualified property. This limitation applies to each income year. The S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's LAMBRA income.

An S corporation's sales or use tax credit may reduce the LAMBRA tax at both the corporate and shareholder levels. One hundred percent (100%) of the LAMBRA credits are passed through to the S corporation shareholders. However, S corporation shareholders are only allowed to claim a credit on the sales or use tax paid or incurred on the purchase of up to \$1 million of qualified property of the S corporation for each taxable year. The shareholders claim their pro-rata share of this credit as recomputed under the California personal income tax law (Part 10).

The sales or use tax credit is first computed for the S corporation using the actual qualified acquisition costs not to exceed \$20 million. The amount of credit passing through to the shareholders is then computed using the actual qualified acquisition costs not to exceed \$1 million. This credit based on the \$1 million limitation is passed through to the shareholders based on their pro rata share. The Schedules K (100S) and K-1 (100S) must state the credit amounts allocable to the shareholders.

**Example:** Corp. Z, an S corporation, purchases \$2 million of qualified property, and elects to take the LAMBRA sales or use tax credit. Corp. Z is allowed to claim a sales or use tax credit of \$50,000 ( $\$2,000,000 \times 7.5\% \times 1/3 = \$50,000$ ). [Cost (not to exceed \$20,000,000) x sales tax rate x 1/3 S corporation credit limitation]

The corporation's two shareholders allocate between them a sales or use tax credit of \$75,000 ( $\$1,000,000 \times 7.5\% = \$75,000$ ). [Cost (not to exceed \$1,000,000) x sales tax rate]

### J. SALES OR USE TAX CREDIT AND THE HIRING CREDIT

**References 17053.45(f)(1); 23645(f)(1)**

The amount of credit(s) allowed, in any income or taxable year, when a taxpayer is eligible to take both the sales or use tax credit and the hiring credit, is limited to the amount of tax imposed on the LAMBRA income. Thus, the taxpayer must aggregate the credits and limit the total amount of credits to tax imposed on the LAMBRA income.

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## CALIFORNIA FRANCHISE TAX BOARD

### K. CREDIT USAGE AND CARRYOVER

**References** 17053.45(d); 17053.45(f)(1); 23645(d); 23645(f)(1)

The portion of the credit that exceeds the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

The aggregate amount of the LAMBRA credit, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the LAMBRA, determined as if that income represented all of the income of the taxpayer.

**Example:** A taxpayer has \$4,900 in LAMBRA credits (sales or use tax credit and hiring credit). Tax imposed on LAMBRA business income is \$4,700 and the taxpayer's overall "net tax"/"tax" is \$4,000. The maximum amount of credit is limited to the lesser of the tax on the LAMBRA business income, or the tax on the taxpayer's overall "net tax"/"tax".

Total LAMBRA credit	\$4,900
Tax on LAMBRA income	\$4,700
<b><u>First limitation:</u></b>	
Lesser of total credit or tax on LAMBRA income	\$4,700
<b><u>Second limitation:</u></b>	
Lesser of tax on LAMBRA income or "net tax"/"tax"	\$4,000
Maximum credit allowed:	
Lesser of <i>LAMBRA tax limitation</i> or "net tax"/"tax" limitation	<u>\$4,000</u>
Total LAMBRA credit	\$4,900
Maximum credit allowed	<u>\$4,000</u>
Carryover	\$ 900

In the event that a credit carryover is allowable for any income or taxable year after the LAMBRA designation has expired; the LAMBRA will be deemed to remain in existence for the purpose of computing the business income limitation.

### L. CREDIT WILL NOT REDUCE CERTAIN TAXES

The LAMBRA sales or use tax credit cannot reduce the:

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## CALIFORNIA FRANCHISE TAX BOARD

- minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- built-in gains tax (S corporations);
- excess net passive income tax (S corporation);
- alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- regular tax below tentative minimum tax.

### M. DEPRECIATION

**References 17053.45(e); 18036; 23645(e); 24916**

Taxpayers electing to utilize the sales or use tax credit are not entitled to increase the basis of the property for which sales or use tax was paid or incurred in connection with the purchase of the property.

Depreciation of the capitalized cost of the asset may be claimed using any method of depreciation allowable beginning in the year the asset is placed in service.

**NOTE:** If the business expense deduction is taken for the same property, depreciation will start with the income or taxable year following the year in which the property is placed in service. The depreciation is calculated on the remaining basis *after* reduction for the sales or use tax credit and business expense deduction amounts.

### N. CREDIT RECAPTURE

**References 17053.45(g)(1); 23645(g)(1)**

Recapture of the LAMBRA sales or use tax credit is required if the qualified property is disposed of or no longer used by the taxpayer in the LAMBRA at any time before the close of the second income or taxable year after the property is placed in service. The amount of the credit previously claimed for that property shall be added to the taxpayer's tax liability in the income or taxable year of that disposition or nonuse.

**Example:** Corp. A purchases property on June 11, 1998 which qualifies Corp. A to take the LAMBRA sales or use tax credit. Corp. A's income year ends December 31 of each year. Corp. A disposes of the property August 5, 2000. The credit is recaptured in the 2000 tax year as the property was disposed of before the close of the second taxable or income year [12/31/2000] after the property was placed in service.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 154 of 307

### ***Special LAMBRA Recapture***

#### ***References 17053.45(b)(2); 17053.45(g)(2); 23645(b)(2); 23645(g)(2)***

The taxpayer must have a *net increase of one or more jobs in the LAMBRA* at the close of the second taxable or income year of doing business within a LAMBRA. If there is not a net increase of one or more jobs, the credit previously claimed shall be added to the taxpayer's "net tax"/"tax" for the second taxable or income year.

The net increase in the number of jobs is determined by applying two tests:

The first test requires a taxpayer to subtract the number of full-time employees (defined as 2,000 paid hours per employee per year) employed in this state in the taxable year prior to commencing business operations in the LAMBRA from the total number of full-time employees employed in this state during the second taxable year after commencing business operations in the LAMBRA.

- ◆ For taxpayers that commence doing business in this state with their LAMBRA business operation, the number of employees for the taxable year prior to commencing business operations in the LAMBRA shall be zero.

If the first test is met, the credit is allowed only if the second test is met which is one or more full-time employees are employed within the LAMBRA.

To determine the first test of the net increase in jobs requirement, the following formula is used:

- The total number of hours worked in this state, by the taxpayer's CA employees (not to exceed 2,000 hours per employee) who are paid an hourly wage, divided by 2,000, plus,
- The total number of months worked in this state, by the taxpayer's CA employees who are salaried employees, divided by 12.

**NOTE:** For taxpayers that first commence doing business in the LAMBRA during the taxable or income year, the divisors "2,000" and "12" shall be multiplied by a fraction, the numerator of which is the number of months of the taxable or income year that the taxpayer was doing business in the LAMBRA and the denominator of which is 12.

To determine the second test of the net increase in jobs requirement, the following formula is used:

- The total number of hours worked in this state, by the taxpayer's LAMBRA employees (not to exceed 2,000 hours per employee) who are paid an hourly wage, divided by 2,000, plus,

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## CALIFORNIA FRANCHISE TAX BOARD

- The total number of months worked in this state, by the taxpayer's LAMBRA employees who are salaried employees, divided by 12.

Example:

A Corporation employs four individuals prior to establishing operations in the LAMBRA on January 1, 1998. The following is the employment information for the employees for the income year prior to operating in the LAMBRA:

- Employee #1: Salaried, employed for 12 months.
- Employee #2: Hourly, full-time; worked 2,080 hours per year.
- Employee #3: Hourly, part-time; worked 1,500 hours per year.
- Employee #4: Hourly, part-time; worked 1,500 hours per year.

The corporation moves its entire operations within the LAMBRA on January 1, 1998. At the end of the first year of operation within the LAMBRA, the corporation employed the following individuals:

- Employee #1: Salaried; employed 24 months.
- Employee #2: Hourly, full-time; worked 2,080 hours during the year.
- Employee #3: Hourly, part-time; worked 2,000 hours during the year.
- Employee #4: Hourly, part-time; worked 1,600 hours during the year.
- Employee #5: Hourly, part-time; worked 1,600 hours during the year.

At the end of the 2nd year of operation in the LAMBRA, the corporation employed the following individuals:

- Employee #1: Salaried; employed 36 months.
- Employee #2: Hourly, full-time; worked 2,080 hours during the year.
- Employee #3: Hourly, part-time; worked 2,000 hours during the year.
- *Employee #4: Hourly, part-time; worked 1,700 hours during the year.*
- *Employee #5: Hourly, part-time; worked 1,900 hours during the year.*

*The first test for the net increase in jobs is computed as follows:*

For the taxable or income year beginning prior to 1/1/98, the relocation date to the LAMBRA:

Hourly Employees:

Employee #2	2000 hours
Employee #3	1500 hours
Employee #4	<u>1500</u> hours

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 156 of 307

---

Total	5000 hours	
	Divide by 2000	
Total hourly employees		2.5 employees

### Salaried Employees

Employee #1	<u>12</u> months	
Total	12 months	
	Divide by 12	
Total Salaried employees		<u>1.0</u> employee

Total employees 3.5 employees  
At the end of the 2nd year of operation in the LAMBRA:

### Hourly Employees:

Employee #2	2000 hours	
Employee #3	2000 hours	
Employee #4	1700 hours	
Employee #5	<u>1900</u> hours	
Total	7600 hours	
Divide by 2000		
Total hourly employees		3.8 employees

### Salaried Employees

Employee #1	<u>12</u> months	
Total	12 months	
	Divide by 12	
Total Salaried employees		<u>1.0</u> employee

Total employees 4.8 employees

Subtract the total employees employed in the year prior to beginning operations in the LAMBRA from the employees employed at the end of the second year of operations in the LAMBRA

Employees employed at the end of the second  
Year of operation in the LAMBRA 4.8 employees

Employees employed prior to relocation

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 157 of 307

---

To the LAMBRA		<u>3.5</u> employees
	Total increase	1.3 employees

The first test of the net increase in jobs requirement has been met. The taxpayer has had a net increase of at least 1 employee in the state of CA at the close of the two year period beginning at the time the taxpayer relocated into the LAMBRA.

- If the taxpayer does not have a net increase of one or more employees during this time period, all LAMBRA tax incentives are required to be recaptured.

*The second test for the net increase in jobs is computed as follows:*

At the end of the 1st year of operation in the LAMBRA:

Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1600 hours
Employee #5	<u>1600</u> hours
Total	7200 hours
	Divide by 2000
Total hourly employees	3.6 employees

Salaried Employees

Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees at the end of the 1st year  
of operation in the LAMBRA 4.6 employees

At the end of the 2nd year of operation in the LAMBRA:

Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1700 hours
Employee #5	<u>1900</u> hours
Total	7600 hours
Divide by 2000	
Total hourly employees	3.8 employees

<p>The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.</p>
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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 158 of 307

---

### Salaried Employees

Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees at the end of the 2nd year  
of operation in the LAMBRA 4.8 employees

The second test of the net increase in jobs requirement has been met. The taxpayer has at least one employee in the LAMBRA in each of the first two years of operations in the LAMBRA.

- If the taxpayer does not have at least one employee in the LAMBRA during these time periods, all LAMBRA tax incentives are required to be recaptured.

## **O. RECORD KEEPING REQUIREMENTS**

To support the sales or use tax credit claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- the property purchased (such as serial numbers, etc.);
- the amount of sales or use tax paid or incurred upon purchase;
- the location where the property is used; and
- if purchased from a manufacturer located outside California, records to substantiate that property of comparable quality and price was not available for purchase in California.

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## **CHAPTER 14      LOCAL AGENCY MILITARY BASE RECOVERY AREA BUSINESS EXPENSE DEDUCTION**

### **A.      INTRODUCTION**

**References** 17268(a); 17268(d)(4); 17268(e)(1); 24356.8(a); 24356.8(d)(1)

For each income or taxable year beginning on or after January 1, 1995, a person or entity (other than an estate or trust) engaged in a trade or business within a Local Agency Military Base Recovery Area (LAMBRA) may elect to treat 40% of the eligible cost of qualified property as a business expense rather than a capital expense.

The deduction shall be allowed for the income or taxable year in which the property is placed in service.

#### ***LAMBRA Locations and Designation Dates***

*For a listing of LAMBRAs, refer to Chapter 1, Section (e). To verify an address, refer to Chapter 1, Section (c).*

### **B.      "TAXPAYER" DEFINED**

**References** 17268(e)(2); 24356.8(d)(2)

A "taxpayer" is a person or entity engaged in a trade or business within a LAMBRA and, for the first two income or taxable years, has a net increase in jobs (defined as 2,000 paid hours per employee per year) of one or more employees in the LAMBRA.

#### ***Allowance of the LAMBRA Business Expense Deduction***

Taxpayers engaged in operations within a LAMBRA are allowed to utilize the LAMBRA business expense deduction beginning in the first year of operations within the LAMBRA even though they cannot fulfill the definition of a qualified taxpayer before the close of the second year of operations in the LAMBRA when the net increase in jobs is computed. If at the end of the second year the taxpayer does not meet the definition of a "qualified taxpayer", the LAMBRA business expense deduction previously utilized needs to be recaptured.

#### ***Estates and Trusts***

**References** 17268(d)(4)

Estates and trusts are not allowed to take the business expense deduction.

#### ***Pass-Through Entities***

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## CALIFORNIA FRANCHISE TAX BOARD

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

### C. QUALIFIED PROPERTY

**References 17268(d); 17268(g); 24356.8(c); 24356.8(g)**

Qualified property is IRC Section 1245 property (as defined in section 1245(a)(3) of the Internal Revenue Code) purchased and placed in service for exclusive use in a trade or business conducted within a LAMBRA. The property must also be purchased and placed in service before the date the LAMBRA designation expires, is no longer binding, or becomes inoperative.

Qualified property under IRC 1245 includes, but is not limited to, tangible personal property (excluding buildings and inventory) that is subject to the allowance for depreciation. This includes most equipment and furnishings purchased for *exclusive use* within a LAMBRA. Office supplies and other small non-depreciable items are not included.

#### ***Leased Property***

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

### D. PROPERTY NOT QUALIFIED

**References 17268(d); 24356.8(c)**

The business expense deduction will not be allowed if the property:

- was transferred between members of an affiliated group;
- was acquired as a gift or inherited;
- was traded for other property;
- is property for which the taxpayer may not make an election under IRC Section 179 due to the provisions of IRC Section 179(d);
- was received from a personal or business relation as defined by IRC Section 267, as modified by 17268(d)(2)(A) and 24356.8(c)(2)(A) for a LAMBRA;



## CALIFORNIA FRANCHISE TAX BOARD

- was received from a personal or business relation as defined by IRC Section 707(b); or
- is described in IRC Section 168(f).

### E. DEDUCTION AMOUNT

**References 17268(f); 24356.8(f)**

For income or taxable years beginning before January 1, 1999, the maximum *deduction* the taxpayer may claim in any income or taxable year is determined by the number of years that have elapsed since the area was designated, as follows:

Income or Taxable Years	Maximum Deduction
Income or taxable year of designation and 1 <sup>st</sup> year thereafter	\$5,000
2 <sup>nd</sup> and 3 <sup>rd</sup> income or taxable year thereafter	\$ 7,500
Each income or taxable year thereafter	\$10,000

For income or taxable years beginning on or after January 1, 1999, the *maximum* deduction the taxpayer may claim in any income or taxable year is determined by the number of years that have elapsed since the area was designated, as follows:

Income or Taxable Years	Maximum Aggregate Cost	Maximum Deduction
Income or taxable year of designation and 1 <sup>st</sup> year thereafter	\$100,000	\$40,000
2 <sup>nd</sup> and 3 <sup>rd</sup> income or taxable year thereafter	\$75,000	\$30,000
Each income or taxable year thereafter	\$50,000	\$20,000

### **Pass-Through Entities**

**References 17268(d)(6); 24356.8(c)(8)**

In the case of pass-through entities, the percentage limitation (40%), of the aggregate cost of all qualified property, shall apply at the entity level and at the partner/shareholder level.

***Personal Income Tax Taxpayers-Married Filing Separate  
References 17268(b)***

In the case of a husband and wife filing separate returns for a taxable year, the applicable deduction shall be equal to one-half (50%) of the otherwise allowable deduction.

**F. BASIS REDUCTION**

The basis of the asset is to be reduced by the amount of the expense deduction claimed.

**G. INTERACTION WITH THE MANUFACTURER'S INVESTMENT CREDIT  
*References 17053.49(b)(1)(C); 23649(b)(1)(C)***

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

**H. ELECTION*****References 17268(a); 17268(c); 24356.8(a); 24356.8(b)***

The taxpayer must make an election to treat the cost of qualified property as a business expense, on the original return filed for the income or taxable year the property is first placed in service. The election must specify the items to which the election applies and the portion of the cost taken into account for purposes of determining the deduction amount.

The election may not be revoked, unless the taxpayer has obtained the consent of the Franchise Tax Board.

***Making the Election***

The election can be made by using:

- [Form FTB 3807](#) – Local Agency Military Base Recovery Area Deduction and Credit Summary.

***Members of an Affiliated Group******References 24356.8(c)(5)-(6)***

For purposes of electing the business expense deduction, all members of an affiliated group shall be treated as one taxpayer. The maximum deduction amount shall be properly apportioned among the members of the affiliated group.

## CALIFORNIA FRANCHISE TAX BOARD

An affiliated group is defined in IRC 1504 as modified by the California Revenue & Taxation Code, to replace "at least 80%" with "more than 50%" each place it appears in IRC 1504(a).

### I. DEPRECIATION

The basis (cost for depreciation purposes) of the property must be reduced by the amount allowed as a deduction. Depreciation of the cost of the property, less the amount deducted, may be claimed using any method of depreciation normally allowed.

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation (IRC Section 179 or CRTC Section 24356) for the same property.

### J. CREATING A NET OPERATING LOSS

Unlike IRC Section 179, there is *no* statutory prohibition on the amount of business expense deduction amount that may create a net operating loss.

### K. ALTERNATIVE MINIMUM TAX

**References 17062; 23457**

The business expense deduction is *not* listed as a tax preference item.

### L. RECAPTURE

**References 17268(h); 24356.8(h)**

The business expense deduction is subject to recapture (added back to income) if, before the *close of the second income or taxable year after* the property is placed in service, the property is sold, disposed of, or is no longer used exclusively within the LAMBRA trade or business.

To recapture the amount deducted, add to the current year income, the amount previously deducted for that property.

**Example:** Corp. A purchases property on June 1, 1998 which qualifies Corp. A to take the LAMBRA business expense deduction. Corp. A's income year ends December 31 of each year. Corp. A disposes of the property August 5, 2000. The previous deduction is added to income in the 2000 tax year because the property was disposed of before the close of the second income or taxable year after the property was placed in service, 12/31/2000.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 164 of 307

### ***Special LAMBRA Recapture***

***References 17268(h); 17268(e)(2); 24356.8(h); 24356.8(d)(2)***

The taxpayer must have a *net increase of one or more jobs in the LAMBRA* at the close of the second taxable or income year of doing business within a LAMBRA. If there is not a net increase of one or more jobs, the amount of the business expense deduction previously claimed will be added back to the taxpayer's income in that year.

The net increase in the number of jobs is determined by applying two tests:

The first test requires a taxpayer to subtract the number of full-time employees (defined as 2,000 paid hours per employee per year) employed in this state in the taxable year prior to commencing business operations in the LAMBRA from the total number of full-time employees employed in this state during the second taxable year after commencing business operations in the LAMBRA.

- ◆ For taxpayers that commence doing business in this state with their LAMBRA business operation, the number of employees for the taxable year prior to commencing business operations in the LAMBRA shall be zero.

If the first test is met, the deduction is allowed only if the second test is met which is one or more full-time employees are employed within the LAMBRA.

To determine the first test of the net increase in jobs requirement, the following formula is used:

- The total number of hours worked in this state, by the taxpayer's CA employees (not to exceed 2,000 hours per employee) who are paid an hourly wage, divided by 2,000, plus,
- The total number of months worked in this state, by the taxpayer's CA employees who are salaried employees, divided by 12.

**NOTE:** For taxpayers that first commence doing business in the LAMBRA during the taxable or income year, the divisors "2,000" and "12" shall be multiplied by a fraction, the numerator of which is the number of months of the taxable or income year that the taxpayer was doing business in the LAMBRA and the denominator of which is 12.

To determine the second test of the net increase in jobs requirement, the following formula is used:

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## CALIFORNIA FRANCHISE TAX BOARD

- The total number of hours worked in this state, by the taxpayer's LAMBRA employees (not to exceed 2,000 hours per employee) who are paid an hourly wage, divided by 2,000, plus,
- The total number of months worked in this state, by the taxpayer's LAMBRA employees who are salaried employees, divided by 12.

### ***Example:***

A Corporation employs four individuals prior to establishing operations in the LAMBRA on January 1, 1998. The following is the employment information for the employees for the income year prior to operating in the LAMBRA:

- Employee #1: Salaried, employed for 12 months.
- Employee #2: Hourly, full-time; worked 2,080 hours per year.
- Employee #3: Hourly, part-time; worked 1,500 hours per year.
- Employee #4: Hourly, part-time; worked 1,500 hours per year.

The corporation moves its entire operations within the LAMBRA on January 1, 1998. At the end of the first year of operation within the LAMBRA, the corporation employed the following individuals:

- Employee #1: Salaried; employed 24 months.
- Employee #2: Hourly, full-time; worked 2,080 hours during the year.
- Employee #3: Hourly, part-time; worked 2,000 hours during the year.
- Employee #4: Hourly, part-time; worked 1,600 hours during the year.
- Employee #5: Hourly, part-time; worked 1,600 hours during the year.

At the end of the 2nd year of operation in the LAMBRA, the corporation employed the following individuals:

- Employee #1: Salaried; employed 36 months.
- Employee #2: Hourly, full-time; worked 2,080 hours during the year.
- Employee #3: Hourly, part-time; worked 2,000 hours during the year.
- Employee #4: Hourly, part-time; worked 1,700 hours during the year.
- Employee #5: Hourly, part-time; worked 1,900 hours during the year.

### ***The first test for the net increase in jobs is computed as follows:***

For the taxable or income year beginning prior to 1/1/98, the relocation date to the LAMBRA:

Hourly Employees:

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 166 of 307

---

Employee #2	2000 hours
Employee #3	1500 hours
Employee #4	<u>1500</u> hours
Total	5000 hours
Divide by 2000	
Total hourly employees	2.5 employees

Salaried Employees	
Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees	3.5 employees
-----------------	---------------

At the end of the 2nd year of operation in the LAMBRA:

Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1700 hours
Employee #5	<u>1900</u> hours
Total	7600 hours
Divide by 2000	
Total hourly employees	3.8 employees

Salaried Employees	
Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees	4.8 employees
-----------------	---------------

Subtract the total employees employed in the year prior to beginning operations in the LAMBRA from the employees employed at the end of the second year of operations in the LAMBRA

Employees employed at the end of the second  
Year of operation in the LAMBRA                      4.8 employees

Employees employed prior to relocation

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 167 of 307

---

To the LAMBRA	<u>3.5</u> employees
Total increase	.3 employees

The first test of the net increase in jobs requirement has been met. The taxpayer has had a net increase of at least 1 employee in the state of CA at the close of the two year period beginning at the time the taxpayer relocated into the LAMBRA.

- If the taxpayer does not have a net increase of one or more employees during this time period, all LAMBRA tax incentives are required to be recaptured.

### ***The second test for the net increase in jobs is computed as follows:***

At the end of the 1st year of operation in the LAMBRA:

#### Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1600 hours
Employee #5	<u>1600</u> hours
Total	7200 hours
Divide by 2000	
Total hourly employees	3.6 employees

#### Salaried Employees

Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees at the end of the 1st year  
of operation in the LAMBRA 4.6 employees

At the end of the 2nd year of operation in the LAMBRA:

#### Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1700 hours
Employee #5	<u>1900</u> hours
Total	7600 hours
Divide by 2000	

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**CALIFORNIA FRANCHISE TAX BOARD**

Total hourly employees                      3.8 employees

**Salaried Employees**

Employee #1                                      12 months

Total    12 months

Divide by 12

Total Salaried employees                      1.0 employee

Total employees at the end of the 2nd year  
of operation in the LAMBRA                      4.8 employees

The second test of the net increase in jobs requirement has been met. The taxpayer has at least one employee in the LAMBRA in each of the first two years of operations in the LAMBRA.

- If the taxpayer does not have at least one employee in the LAMBRA during these time periods, all LAMBRA tax incentives are required to be recaptured.

**M. CHECKLIST TO DETERMINE ELIGIBILITY FOR THE BUSINESS EXPENSE DEDUCTION**

Checklist Items	Yes	No
Is the taxpayer qualified? <ul style="list-style-type: none"> <li>• Is a trade or business conducted within a LAMBRA? See the "<i>Taxpayer Defined</i>" section.</li> </ul>		
Is the property qualified? <ul style="list-style-type: none"> <li>• Qualified property is Section 1245 property. See the <i>Qualified Property</i> section.</li> <li>• Is the property used exclusively within the boundaries of the LAMBRA?</li> </ul>		
Is the correct deduction amount claimed? <ul style="list-style-type: none"> <li>• Limitation differs based on year of designation. See <i>Deduction Amount</i> section.</li> <li>• Verify purchase on invoices or receipts.</li> <li>• Verify the date the property is placed in service.</li> </ul>		
Was a timely election made? <ul style="list-style-type: none"> <li>• Election made on original return?</li> <li>• Form FTB 3807 – Local Agency Military Base Recovery Area Deduction and Credit Summary, or a separate</li> </ul>		

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## CALIFORNIA FRANCHISE TAX BOARD

statement attached to the return?		
Was the property acquired through a valid transaction? <ul style="list-style-type: none"><li>• See the <i>Property Not Qualified</i> section.</li></ul>		
Was correct depreciation claimed? <ul style="list-style-type: none"><li>• Basis must be reduced by the amount of the business expense deduction before depreciation is computed.</li><li>• IRC Section 179 expense or additional first year depreciation may not be claimed for qualified property for which the business expense deduction is claimed.</li></ul>		
Is the deduction subject to recapture? <ul style="list-style-type: none"><li>• Was the property sold, disposed of or no longer used by the taxpayer in the LAMBRA, before the close of the second income or taxable year after the property was placed in service?</li><li>• Check current location of the qualified property.</li><li>• Check sale or disposal date of qualified property.</li></ul>		

### N. RECORD KEEPING REQUIREMENTS

To support the business expense deduction claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- the property purchased (such as serial numbers, etc.); and
- the location where the property is used

**CHAPTER 15      LOCAL AGENCY MILITARY BASE RECOVERY AREA  
NET OPERATING LOSS****A.      INTRODUCTION*****References 17276.1(a); 17276.5(a); 24416.1(a); 24416.5(a)***

Taxpayers are required to annually report their income and expenses. Due to possible fluctuations in income and expenses, a taxpayer may have substantial profits in one year, while losses in another. In years where expenses exceed income, a net operating loss (NOL) occurs.

For each income or taxable year beginning on or after January 1, 1995, a qualified taxpayer engaged in a trade or business within a designated Local Agency Military Base Recovery Area (LAMBRA) may elect to carry forward 100% of its NOLs for a 15 year period.

An LAMBRA NOL cannot be generated until the first taxable or income year beginning on or after the area has been officially designated as an LAMBRA.

Prior to January 1, 1998, the applicable LAMBRA NOL code sections were:

- 17276 - 17276.1, 17276.2(c), 17276.3
- 24416 - 24416.1, 24416.2(c), 24416.3

For taxable or income years beginning on or after January 1, 1998, the LAMBRA NOL code sections are:

- 17276 - 17276.1, 17276.3, 17276.5
- 24416 - 24416.1, 24416.3, 24416.5

The following references in this chapter are to the new code section numbers.

***LAMBRA Locations and Designation Dates***

*For a listing of LAMBRA's, refer to Chapter 1, Section (e). To verify an address, refer to Chapter 1, Section (c).*

**B.      QUALIFIED TAXPAYER*****References 17276.5(a); 17276.5(a)(3); 24416.5(a); 24416.5(a)(4)***

For purposes of the LAMBRA NOL deduction, a qualified taxpayer includes a person or entity that is engaged in a trade or business within a LAMBRA.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 171 of 307

Taxpayers doing business in an area that was previously not a qualified area, but later designated as qualified, are allowed to utilize the special tax incentives for the taxable or income year beginning on or after the date the area is designated as a LAMBRA.

Further, the taxpayer, for the first two income or taxable years, must have a net increase in jobs of one or more employees in the LAMBRA and California. See Section (i).

### ***Pass-Through Entities***

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

### **C. ELECTION**

***References 17276.1(b); 17276.5(b); 17276.5(c); 17276.5(d); 24416.1(c); 24416.5(b); 24416.5(c); 24416.5(d)***

Qualified taxpayers must make an election to claim the LAMBRA NOL. The election must be filed with the original return, timely filed, for the income or taxable year in which the NOL is incurred. The election is irrevocable.

If the taxpayer is eligible to qualify for an NOL under more than one section (operation in more than one economic development area, new small business etc.), the taxpayer must choose which section to elect. Taxpayers are prohibited from carrying over any other type of NOL from the same tax year other than the loss from the subdivision elected.

Failure to elect to compute the NOL deduction under section 17276.1 or 24416.1 will cause the NOL to be subject to the limitations and restrictions under section 17276 or 24416 (general NOL).

### ***Making the Election***

The election can be made by using:

- [Form FTB 3807](#) – Local Agency Military Base Recovery Area Deduction and Credit Summary.

In addition, the form FTB 3807 must be filed for each year in which the NOL deduction is taken.

### **D. LAMBRA NOL COMPUTATION - GENERAL PROVISIONS**

***References 17276.1; 17276.5(a)(4); 24416.1; 24416.5(a)(5)***

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A LAMBRA NOL is the loss attributable to the qualified taxpayer's business activities within a LAMBRA, prior to the LAMBRA expiration date. LAMBRA NOLs are determined under IRC Section 172, as modified by CRTC Sections 17276.1, 17276.5, 24416.1, and 24416.5.

**E. LAMBRA NOL - LOSS ATTRIBUTED TO BUSINESS ACTIVITY**

***References 17276.5(a)(4); 24416.5(a)(5)***

A LAMBRA NOL is the loss attributable to the qualified taxpayer's business activities within a LAMBRA prior to the LAMBRA expiration date. Non-business income and/or loss are excluded from the calculation of the LAMBRA NOL.

If a business is located within and outside of a LAMBRA, the taxpayer must determine the portion of the total business loss that is attributable to the LAMBRA.

- Business loss is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxpayers conducting business operations within and without a LAMBRA, business loss is apportioned to the LAMBRA by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

**(i) Property Factor – Loss Apportionment**

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LAMBRA* during the income or taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

**(ii) Payroll Factor – Loss Apportionment**

The payroll factor is a fraction.

## CALIFORNIA FRANCHISE TAX BOARD

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the LAMBRA during the income or taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

**Example** - Two-factor apportionment: For the income year ending 12/31/99, Corp. A operates within and outside an LAMBRA. Corp. A's business loss of \$13,000 needs to be apportioned to the LAMBRA. The following amounts apply to Corp. A's property and payroll:

LAMBRA Property	\$40,000
Worldwide (WW) Property	\$100,000
LAMBRA Payroll	\$5,000
WW Payroll	\$10,000

LAMBRA Property/WW = .40

Property

LAMBRA Payroll/WW = .50

Payroll

.40 + .50 = .90

.90/2 = .45 LAMBRA Apportionment Factor

Business loss	\$(13,000)
Apportionment Factor	<u>x 0.45</u>
LAMBRA NOL	\$(5,850)

### (iii) Apportionment – Combined Groups

For members of a combined group, the LAMBRA NOL calculation will be based on the combined groups worldwide business loss (before CA apportionment). The numerator of the apportionment formula will be based on each LAMBRA taxpayer's separate LAMBRA payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

**Example:** For the income year ending 12/31/99, Parent corporation A has two subsidiaries, B and C. Corporations A and B operate within an LAMBRA. The combined group operates within and outside California and apportions its income or loss to California using Schedule R. The combined group's business loss is \$1,000,000.

Business loss apportioned to the LAMBRA was determined as follows:

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# CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 174 of 307

	A	B	C	Combined
<b>Property Factor</b>				
LAMBRA Property	\$2,000,000	\$1,000,000	\$0	\$3,000,000
Worldwide Property				\$5,000,000
Apportionment %	40%	20%		60%
<b>Payroll Factor</b>				
LAMBRA Payroll	\$2,000,000	\$800,000	\$0	\$2,800,000
Worldwide Payroll				\$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
<b>Business Loss</b>				\$(1,000,000)
LAMBRA NOL	\$(450,000)	\$(200,000)		\$(650,000)

## (iv) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an LAMBRA and one outside the LAMBRA. Eighty percent (80%) of the S corporation's business is attributable to the LAMBRA. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3807 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the LAMBRA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary Loss	200,000
LAMBRA business expense deduction	(5,000)*

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## CALIFORNIA FRANCHISE TAX BOARD

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Ray's unreimbursed employee expenses from Schedule A	(2,000)
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\*The LAMBRA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LAMBRA loss is computed as follows:

Ray's LAMBRA salary (\$100,000 x 50%)	\$50,000
Mary's LAMBRA salary (\$75,000 x 100%)	75,000
Pass-through ordinary loss from the S-Corp. (\$200,000 x 80%)	(160,000)
LAMBRA business expense deduction from the S- Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	<u>(1,000)</u>
Total LAMBRA loss	<u>\$(41,000)</u>

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of LAMBRA NOL since they are not related to trade or business activities.

### F. LAMBRA NOL LIMITED BY GENERAL NOL

#### **References 17276; 24416**

The LAMBRA NOL is compared to the NOL computed under the general NOL provisions of section 17276 / 24416, *prior* to the 50% reduction. The LAMBRA NOL carryover is limited to the lesser of the LAMBRA NOL or the general NOL (prior to the 50% reduction). NOTE: If the LAMBRA NOL is limited by the general NOL amount, (prior to the 50% reduction), the amount can still be characterized as an LAMBRA NOL and allowed to be carried over at 100% for 15 years. An election must be made to characterize the NOL as an LAMBRA NOL.

**Example:** Corp. B incurred the following loss:

Income from business operations	\$160,000
Interest from investment which is unrelated to Corp. B's business operations	15,000
Expenses of business operations	<u>(189,000)</u>
<b>Net loss</b>	<b><u>(\$14,000)</u></b>

To determine the NOL carryover attributed to the LAMBRA business operations, the following must be done:

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## CALIFORNIA FRANCHISE TAX BOARD

1. Determine NOL per CRTC 24416 (prior to 50% reduction)
2. Determine NOL per CRTC 24416.5 (remove non-business items)

The NOL carryover is limited to the lesser of the general NOL (item 1) or the LAMBRA NOL (item 2) above.

1. CRTC 24416 "general" NOL - prior to 50% reduction  
Net loss of Corp. B (\$14,000)
2. CRTC 24416.5 LAMBRA NOL - exclude non-business income/loss

Income from operations	\$160,000
Expenses of operations	<u>(189,000)</u>
Net loss of Corp. B (LAMBRA)	(\$29,000)

Pattern 1: Assume Corp. B operates entirely within the LAMBRA. Corp. B is allowed to carry over the lesser of the "general" NOL, or the LAMBRA NOL; in this case \$14,000.

Pattern 2: Assume Corp. B conducts 40% of its total business operations in the LAMBRA, as computed as discussed in Section (e). Because Corp. B only has 40% of its business operation in the LAMBRA, the \$29,000 business loss must be apportioned before comparing it to the "general" NOL. In this example, the LAMBRA loss is \$11,600 (\$29,000 x 40%). Corp. B is allowed to carry over the lesser of the "general" NOL, or the LAMBRA NOL; in this case, \$11,600.

### **G. CARRYOVER / CARRYBACK**

**References 17276.1(a); 17276.5(a); 24416.1(a); 24416.5(a)**

For each income or taxable year beginning on or after January 1, 1995, a qualified taxpayer engaged in a trade or business within a designated LAMBRA may elect to carryover 100% of its NOLs. No NOL carrybacks are allowed.

The NOLs may be carried over to each of the 15 income or taxable years following the year of loss, or until exhausted, whichever occurs first. If an NOL carryover remains after the LAMBRA designation has expired, the LAMBRA shall be deemed to remain in existence for purposes of computing the LAMBRA income limitation, and for purposes of allowing the LAMBRA NOL deduction.

**NOTE:** Financial institutions, as defined in IRC Sections 585, 586, or 593, using bad debt reserve methods may carry the loss forward for a maximum of 5 income years.



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 177 of 307

### H. LAMBRA NOL DEDUCTION - GENERAL PROVISIONS

**References 17276.5(a)(5); 17276.5(a)(6)(B); 24416.5(a)(6); 24416.5(a)(7)(B)**

The LAMBRA NOL deduction can only offset business income attributable to operations of the taxpayer within the designated LAMBRA.

In the event that a LAMBRA NOL deduction is allowable for any taxable or income year after the LAMBRA designation has expired, the LAMBRA will be deemed to remain in existence for the purpose of computing the business income limitation.

#### (i) Income Attributed to Business Activity

**References 17276.5(a)(6); 24416.5(a)(7)**

If a business is located within and outside of a LAMBRA, the taxpayer must determine the portion of the California business income that is attributable to the LAMBRA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1998, business income shall be apportioned to the LAMBRA by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning before January 1, 1998, business income is apportioned to the LAMBRA by multiplying the worldwide business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

#### (ii) Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LAMBRA* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

- For income or taxable years beginning before January 1, 1998, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

### (iii) Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the LAMBRA during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1998, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.
- For income or taxable years beginning before January 1, 1998, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

**Example** - Two-factor apportionment: For the income year ending 12/31/99, Corp. A operates within and outside an LAMBRA. California business income of \$13,000 needs to be apportioned to the LAMBRA. The following amounts apply to Corp. A's property and payroll:

LAMBRA Property	\$40,000
CA Property	\$100,000
LAMBRA Payroll	\$5,000
CA Payroll	\$10,000

LAMBRA Property/CA = .40

Property

LAMBRA Payroll/CA = .50

Payroll

.40 + .50 = .90

.90/2 = .45 LAMBRA Apportionment Factor

Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
LAMBRA Business Income	\$5,850

## CALIFORNIA FRANCHISE TAX BOARD

### (iv) Apportionment – Combined Groups

For income or taxable years beginning before January 1, 1998: For members of a combined group, the income limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each LAMBRA taxpayer's separate LAMBRA payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to Chapter 23, Section (g)(iv).

For income or taxable years beginning on or after 1/1/1998: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the LAMBRA. The numerator of the apportionment formula will be based on each LAMBRA taxpayer's separate LAMBRA property and payroll amounts and the denominator will be based on each LAMBRA taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the LAMBRA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate LAMBRA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LAMBRA was determined as follows:

	A	B
<u>Property Factor</u>		
LAMBRA Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
LAMBRA Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
Average Apport. %	100%	73.33%

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 180 of 307

(Property + Payroll  
Factors)/2

Apportioned		
Business Income	\$228,000	\$250,000
LAMBRA Income	\$228,000	\$183,333

### (v) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an LAMBRA and one outside the LAMBRA. Eighty percent (80%) of the S corporation's business is attributable to the LAMBRA. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3807 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the LAMBRA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
LAMBRA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The LAMBRA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LAMBRA income is computed as follows:

Ray's LAMBRA salary (\$100,000 x 50%)	\$50,000
Mary's LAMBRA salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp.	32,000

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## CALIFORNIA FRANCHISE TAX BOARD

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(\$40,000 x 80%)	
LAMBRA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	<u>(1,000)</u>
Total LAMBRA income	\$151,000

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of LAMBRA income since they are not related to trade or business activities.

### I. NET INCREASE IN JOBS REQUIREMENT

**References 17053.45(b)(2); 17053.45(g)(2); 23645(b)(2); 23645(g)(2)**

The taxpayer must have a *net increase of one or more jobs in the LAMBRA* at the close of the second taxable or income year of doing business within a LAMBRA. If there is not a net increase of one or more jobs, the LAMBRA NOL previously incurred shall convert to a general NOL.

The net increase in the number of jobs is determined by applying two tests:

The first test requires a taxpayer to subtract the number of full-time employees (defined as 2,000 paid hours per employee per year) employed in this state in the taxable year prior to commencing business operations in the LAMBRA from the total number of full-time employees employed in this state during the second taxable year after commencing business operations in the LAMBRA.

- ◆ For taxpayers that commence doing business in this state with their LAMBRA business operation, the number of employees for the taxable year prior to commencing business operations in the LAMBRA shall be zero.

If the first test is met, the deduction is allowed only if the second test is met which is one or more full-time employees are employed within the LAMBRA.

To determine the first test of the net increase in jobs requirement, the following formula is used:

- The total number of hours worked in this state, by the taxpayer's CA employees (not to exceed 2,000 hours per employee) who are paid an hourly wage, divided by 2,000, plus,
- The total number of months worked in this state, by the taxpayer's CA employees who are salaried employees, divided by 12.

## CALIFORNIA FRANCHISE TAX BOARD

**NOTE:** For taxpayers that first commence doing business in the LAMBRA during the taxable or income year, the divisors “2,000” and “12” shall be multiplied by a fraction, the numerator of which is the number of months of the taxable or income year that the taxpayer was doing business in the LAMBRA and the denominator of which is 12.

To determine the second test of the net increase in jobs requirement, the following formula is used:

- The total number of hours worked in this state, by the taxpayer's LAMBRA employees (not to exceed 2,000 hours per employee) who are paid an hourly wage, divided by 2,000, plus,
- The total number of months worked in this state, by the taxpayer's LAMBRA employees who are salaried employees, divided by 12.

***Example:***

A Corporation employs four individuals prior to establishing operations in the LAMBRA on January 1, 1998. The following is the employment information for the employees for the income year prior to operating in the LAMBRA:

- Employee #1: Salaried, employed for 12 months.
- Employee #2: Hourly, full-time; worked 2,080 hours per year.
- Employee #3: Hourly, part-time; worked 1,500 hours per year.
- Employee #4: Hourly, part-time; worked 1,500 hours per year.

The corporation moves its entire operations within the LAMBRA on January 1, 1998. At the end of the first year of operation within the LAMBRA, the corporation employed the following individuals:

- Employee #1: Salaried; employed 24 months.
- Employee #2: Hourly, full-time; worked 2,080 hours during the year.
- Employee #3: Hourly, part-time; worked 2,000 hours during the year.
- Employee #4: Hourly, part-time; worked 1,600 hours during the year.
- Employee #5: Hourly, part-time; worked 1,600 hours during the year.

At the end of the 2nd year of operation in the LAMBRA, the corporation employed the following individuals:

- Employee #1: Salaried; employed 36 months.
- Employee #2: Hourly, full-time; worked 2,080 hours during the year.
- Employee #3: Hourly, part-time; worked 2,000 hours during the year.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 183 of 307

- Employee #4: Hourly, part-time; worked 1,700 hours during the year.
- Employee #5: Hourly, part-time; worked 1,900 hours during the year.

### ***The first test for the net increase in jobs is computed as follows:***

For the taxable or income year beginning prior to 1/1/98, the relocation date to the LAMBRA:

#### Hourly Employees:

Employee #2	2000 hours
Employee #3	1500 hours
Employee #4	<u>1500</u> hours
Total	5000 hours
Divide by 2000	
Total hourly employees	2.5 employees

#### Salaried Employees

Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees 3.5 employees

### At the end of the 2nd year of operation in the LAMBRA:

#### Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1700 hours
Employee #5	<u>1900</u> hours
Total	7600 hours
Divide by 2000	
Total hourly employees	employees

#### Salaried Employees

Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees 4.8 employees

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 184 of 307

Subtract the total employees employed in the year prior to beginning operations in the LAMBRA from the employees employed at the end of the second year of operations in the LAMBRA

Employees employed at the end of the second Year of operation in the LAMBRA	4.8 employees
Employees employed prior to relocation To the LAMBRA	<u>3.5</u> employees
Total increase	1.3 employees

The first test of the net increase in jobs requirement has been met. The taxpayer has had a net increase of at least 1 employee in the state of CA at the close of the two year period beginning at the time the taxpayer relocated into the LAMBRA.

- If the taxpayer does not have a net increase of one or more employees during this time period, all LAMBRA tax incentives are required to be recaptured.

### ***The second test for the net increase in jobs is computed as follows:***

At the end of the 1st year of operation in the LAMBRA:

#### Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1600 hours
Employee #5	<u>1600</u> hours
Total	7200 hours
Divide by 2000	
Total hourly employees	3.6 employees

#### Salaried Employees

Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees at the end of the 1st year  
of operation in the LAMBRA 4.6 employees

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 185 of 307

At the end of the 2nd year of operation in the LAMBRA:

Hourly Employees:

Employee #2	2000 hours
Employee #3	2000 hours
Employee #4	1700 hours
Employee #5	<u>1900</u> hours
Total	7600 hours
Divide by 2000	
Total hourly employees	3.8 employees

Salaried Employees

Employee #1	<u>12</u> months
Total	12 months
Divide by 12	
Total Salaried employees	<u>1.0</u> employee

Total employees at the end of the 2nd year  
of operation in the LAMBRA 4.8 employees

The second test of the net increase in jobs requirement has been met. The taxpayer has at least one employee in the LAMBRA in each of the first two years of operations in the LAMBRA.

- If the taxpayer does not have at least one employee in the LAMBRA during these time periods, all LAMBRA tax incentives are required to be recaptured.

### **J. S CORPORATIONS**

***References 23802(d)(1)-(2)***

For qualified taxpayers electing S corporation status *after* the designation of the LAMBRA, the qualified NOL attributed to the C corporation years cannot offset S corporation net income.

### **K. ALTERNATIVE MINIMUM TAX**

***References 17062; 23456***

Taxpayers claiming a LAMBRA NOL deduction must also determine their NOL for alternative minimum tax purposes.

### **L. FLOW-THROUGH LOSSES**

***References 17087.5; 17087.6; 17851; 23800; 24271***

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The income and loss that will flow through to a shareholder, beneficiary, partner, or member, retains the same characteristics as it had with the pass-through entity.

The election (Section C) to claim an NOL must be made by the entity and each investor on their respective returns. The election by the entity to utilize the LAMBRA NOL does not extend to, or bind the investor to utilizing the LAMBRA NOL. Further, the investor may utilize the LAMBRA NOL if the entity utilized the general NOL provisions, or had no NOL. Each taxpayer must determine if they in fact have a NOL, and then decide whether the general or LAMBRA NOL will be utilized.

## **CHAPTER 16      MANUFACTURING ENHANCEMENT AREA HIRING CREDIT**

### **A.      INTRODUCTION**

***References 17053.47(a); 17053.47(b)(5)(B); 23622.8(a); 23622.8(b)(5)(B)***

For each taxable or income year beginning on or after January 1, 1998, the California Revenue and Taxation Code (CRTC) provides a hiring credit for "qualified" taxpayers who operate or invest in a business located within a designated Manufacturing Enhancement Area (MEA) and hire "qualified employees" and pay them "qualified wages". MEAs were established in California to stimulate development in selected economically depressed areas.

The MEA hiring credit applies to those employees hired after the designation date of the MEA. (October 1, 1998)

#### ***Geographic Boundaries and Designation Dates***

For a listing of manufacturing enhancement areas and designation dates, refer to Chapter 1, Section (f). For verifying an address, refer to Chapter 1, Section (c).

### **B.      QUALIFIED TAXPAYER**

***References 17053.47(b)(6); 23622.8(b)(6)***

A *qualified taxpayer* is any taxpayer engaged in a trade or business within an MEA and who meets all of the following requirements:

- Is engaged in those lines of business described in Codes 2011 to 3999, inclusive, of the *Standard Industrial Classification (SIC) Manual* published by the United States Office of Management and Budget, 1987 edition;

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## CALIFORNIA FRANCHISE TAX BOARD

- At least 50 percent of the qualified taxpayer's work force hired after the designation of the MEA, is composed of individuals who, at the time of hire, are residents of the county in which the MEA is located; and
- Of this 50 percent of local hires, at least 30 percent were qualified disadvantaged individuals.

### ***Controlled Groups***

***References 17053.47(c)(1)(A); 17053.47(c)(1)(C); 23622.8(c)(1)(A); 23622.8(c)(1)(C)***

All employees of trades or businesses that are under common control, or members of the same controlled group of corporations, shall be treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC 1563(a) as modified by the California Revenue & Taxation Code, to replace "*at least 80%*" with "*more than 50%*". The determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of IRC Section 1563.

**NOTE:** Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

### ***Acquired Businesses***

***References 17053.47(c)(2); 23622.8(c)(2)***

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues to be employed in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues to be employed in that business.

**NOTE:** The new employer, "steps into the shoes" of the old employer for purposes of incurring future credits.

## **C. QUALIFIED WAGES**

***References 17053.47(b)(1); 17053.47(b)(2); 17053.47(e); 23622.8(b)(1); 23622.8(b)(2)***

*Qualified wages* are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer. For qualified employees hired before the expiration date of the MEA, qualified wages paid or incurred within the 60-month period beginning with the first day the employee commences employment

## CALIFORNIA FRANCHISE TAX BOARD

with the taxpayer shall continue to qualify for the credit after the zone expiration date, as if the MEA designation were still in existence and binding.

Qualified *wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

### ***Annual Wage Limitation***

The total amount of qualified wages that may be taken into account for purposes of claiming the credit shall not exceed two million dollars (\$2,000,000) each income or taxable year.

### ***Estates and Trusts***

In the case of an estate or trust, the qualified wages shall be apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages have been apportioned, shall be treated as the employer with respect to those wages.

### ***Non-Qualified Wages***

Qualified wages *do not* include any wages paid or incurred on or after the area expiration date except as noted previously for qualified employees hired prior to the expiration of the MEA.

### ***Minimum Wage Chart***

<b><i>EFFECTIVE DATE</i></b>	<b><i>MINIMUM WAGE</i></b>	<b><i>MAXIMUM HOURLY WAGE - HIRING CREDIT</i></b>
<b><i>March 1, 1998 to Current</i></b>	\$5.75	\$8.62 (150% of \$5.75)

## **D. QUALIFIED EMPLOYEE**

***References 17053.47(b)(5); 23622.8(b)(5)***

A *qualified employee* is an individual who satisfies all of the following:

### **ANNUAL TESTS**

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

- At least 90% of the employee's work for the taxpayer, during the taxable or income year, must be directly related to the conduct of the taxpayer's trade or business located in the MEA;
- At least 50 percent of the employee's services for the taxpayer, during the taxable or income year, must be performed within the boundaries of the MEA;

### **TIME OF HIRE TESTS**

- The employee is hired after the area was designated as a MEA; and
- Immediately preceding commencement of employment with the taxpayer, the employee is any of the following:
  - Eligible for services under the federal Job Training Partnership Act (JTPA) or its successor;
  - Registered under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor;
  - Certified eligible by the Employment Development Department under the federal Targeted Jobs Credit Program (TJTC), or its successor, whether or not this program is in effect.

### ***Seasonal Employees***

**References 17053.47(b)(1)(C); 17053.47(b)(7); 23622.8(b)(1)(C); 23622.8(b)(7)**

"Seasonal employment" means employment that has regular and predictable substantial reductions in business operations.

Reemployment of an individual, in connection with any increase (including a regularly occurring seasonal increase) in business operations, does not constitute commencement of employment for purposes of the MEA hiring credit.

### ***Leased Employees***

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer can be identified due to the legal obligation to pay the payroll taxes of the employee, and as to who has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, *Employer's Supplemental Tax Guide* provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship.

## **E. CREDIT COMPUTATION**

**References 17053.47(a); 17053.47(b)(1)(B); 23622.8(a); 23622.8(b)(1)(B)**

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## CALIFORNIA FRANCHISE TAX BOARD

For each income or taxable year beginning on or after January 1, 1998, a hiring credit shall be allowed to a qualified taxpayer for hiring a qualified employee for employment within the MEA. The credit shall be equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The total amount of qualified wages used to compute the MEA hiring credit cannot exceed \$2,000,000 per each income or taxable year.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit will be used.

**Example:** An employee was hired 12/1/1998, and the taxpayer is completing the tax return for the year ending 12/31/1999. For the period 1/1/1999 to 11/30/1999, the hiring credit is based on 50% of qualified wages. For the period 12/1/1999 to 12/31/1999, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

**Example:** An employee is hired 12/1/1998, is temporarily laid off 2/1/1999, and is rehired 4/1/1999. The 50% credit range runs from 12/1/1998 to 11/30/1999 regardless of the layoff period between 2/1/1999 and 3/31/1999.

### F. CREDIT ADJUSTMENTS & LIMITATIONS

**References 17053.47(i); 23622.8(h)**

If the qualified taxpayer is allowed the MEA hiring credit for qualified wages paid to an employee, only that one credit is allowed to the taxpayer with respect to those qualified wages for that employee.

## CALIFORNIA FRANCHISE TAX BOARD

### ***Reduction for Other Tax Credits***

#### ***References 17053.47(f); 23622.8(e)***

The MEA hiring credit shall be reduced by the credits allowed under California Revenue & Taxation Code Section 17053.7 & 23621 (Jobs Tax Credit), and the federal credit allowed under IRC Section 51 (Work Opportunity Tax Credit – WOTC)

### **G. WAGE EXPENSE REDUCTION**

#### ***References 17053.47(f); 23622.8(e)***

The taxpayer must reduce any deduction for wages by the amount of the MEA hiring credit allowed (including any current year credit to be carried forward).

### **H. BUSINESS INCOME ACTIVITY LIMITATION**

#### ***References 17053.47(h)(2); 23622.8(g)(2)***

The amount of the hiring credit claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's MEA business income in any year. Depending on the tax year involved, the MEA business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the MEA. Non-business income or loss is not included in the calculation of business income from the MEA. Each taxpayer claiming the credit must compute the MEA business income and resulting tax.

**Example:** Corp. A operates entirely within an MEA. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	2,000
Business expenses	(17,000)
<b>Net taxable income before taxes</b>	<b>\$15,000</b>

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	(17,000)
<b>Net Business Income</b>	<b>\$13,000</b>

## CALIFORNIA FRANCHISE TAX BOARD

To determine the MEA hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	\$13,000
x 8.84%	<u>x .0884</u>
Tax associated with business income	\$1,149

In this example, the taxpayer can offset the tax of \$1,149 with the hiring credit available (up to \$1,149).

**NOTE:** "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

### **I. GENERAL PROVISIONS – APPORTIONMENT OF BUSINESS INCOME** **References 17053.47(h)(2); 17053.47(h)(3); 23622.8(g)(2); 23622.8(g)(3)**

If a business is located within and outside of the MEA, the taxpayer must determine the portion of the total business income that is attributable to the MEA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1998, business income shall be apportioned to the MEA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

#### **(i) Property Factor – Income Apportionment**

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the MEA* during the income or taxable year. The denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

#### **(ii) Payroll Factor – Income Apportionment**

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the MEA* during



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 193 of 307

the income or taxable year. The denominator is the total compensation paid to employees working for the taxpayer *within California* during the income or taxable year.

**Example:** Corp. A operates within and outside the MEA. California business income of \$13,000 needs to be apportioned to the MEA. The following amounts apply to Corp. A's property and payroll:

MEA Property	\$40,000
CA Property	\$100,000
MEA Payroll	\$.5,000
CA Payroll	\$10,000

$$\begin{aligned}\text{MEA Property/CA Property} &= .40 \\ \text{MEA Payroll/CA Payroll} &= .50 \\ .90/2 &= .45 \quad \text{MEA Apportionment Factor}\end{aligned}$$

Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
MEA Business Income	\$5,850
Current Tax Rate	<u>x .0884</u>
Tax attributable to MEA business income	\$ 517

### (iii) Apportionment – Combined Groups

For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the MEA. The numerator of the apportionment formula will be based on each MEA taxpayer's separate MEA property and payroll amounts and the denominator will be based on each MEA taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the MEA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate MEA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the MEA was determined as follows:

A

B

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 194 of 307

### Property Factor

MEA Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%

### Payroll Factor

MEA Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%

Average Apport. %	100%	73.33%
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(Property + Payroll  
Factors)/2

Apportioned Business Income	\$228,000	\$250,000
MEA Income	\$228,000	\$183,333

### **(iv) Apportioning for Personal Income Tax Taxpayers**

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within the MEA and one outside the MEA. Eighty percent (80%) of the S corporation's business is attributable to the MEA. (**NOTE:** This percentage was determined by the S corporation, using Worksheet II from the FTB 3808 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the MEA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 195 of 307

MEA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The MEA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's MEA income is computed as follows:

Ray's MEA salary (\$100,000 x 50%)	\$50,000
Mary's MEA salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. (\$40,000 x 80%)	32,000
LAMBRA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	<u>(1,000)</u>
<b>Total MEA income</b>	<b>\$151,000</b>

Ray and Mary must compute the tax on the total MEA income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*; the 1999 tax on \$151,000 is \$10,659. The \$10,659 is the first limitation on MEA credits for the 1999 tax year. The second limitation on the credits is the *net tax* on all income.

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of MEA income since they are not related to trade or business activities.

**Example:** John Doe is the President and shareholder of an S corporation with one location operating entirely within the MEA. John receives a salary of \$50,000 from the corporation. John's CA AGI is made up of the following items:

S corporation salary	\$50,000
Interest on Savings Account	5,000
Dividends	2,000
Capital Gain	10,000
S corp. ordinary loss from Schedule K-1(100S)	<u>(60,000)</u>
CA AGI	\$7,000

John's MEA income is computed as follows:

S corporation salary	\$50,000
S corporation ordinary loss	<u>(60,000)</u>

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## CALIFORNIA FRANCHISE TAX BOARD

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Total LAMBRA income/(loss)	\$(10,000)
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John's MEA hiring credit from Schedule K-1 (100S) totals \$3,000. Since John has negative MEA income, he cannot use the MEA hiring credit. The hiring credit claimed cannot exceed the amount of tax on the MEA business income in any year. However, carryover of the unused credit would be allowed.

### J. S CORPORATIONS

**References 17053.47(f); 23622.8(e); 23803(a)(1)(A); 23803(a)(1)(F)**

An S corporation's hiring credit may reduce the MEA tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's MEA income.

One hundred percent (100%) of the MEA credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

**Example:** An S corporation computes a \$3,000 hiring credit. The S corporation's credit is \$1,000 and the wage reduction is \$1,000. The \$3,000 credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is \$3,000.

### K. CREDIT USAGE & CARRYOVER

The total amount of the MEA credit, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the MEA, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

If a credit carryover remains after the MEA has expired, is no longer binding, or becomes inoperative, the MEA shall be deemed to remain in existence for purposes of computing the taxpayer's business income attributable to the MEA.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 197 of 307

**Example:** A taxpayer has a \$4,900 MEA hiring credit. Tax imposed on MEA business income is \$4,700, and the taxpayer's overall "net tax"/"tax" is \$4,000. The taxpayer would be eligible to claim a \$4,000 maximum hiring credit.

Total MEA hiring credit	\$4,900
Tax on MEA income	\$4,700
<b><u>First limitation:</u></b>	
Lesser of total credit or tax on MEA income	\$4,700
<b><u>Second limitation:</u></b>	
Lesser of tax on MEA Income or "net tax"/"tax"	\$4,000
Maximum credit allowed:	
Lesser of <i>MEA tax limitation</i> or " <i>net tax</i> "/" <i>tax</i> " <i>limitation</i>	<u>\$4,000</u>
Total hiring credit	<u>\$4,900</u>
Maximum credit allowed	<u>\$4,000</u>
Carryover	\$ 900

### L. CREDIT WILL NOT REDUCE CERTAIN TAXES

The MEA hiring credit cannot reduce the:

- minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- built-in gains tax (S corporations);
- excess net passive income tax (S corporation);
- alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- regular tax below tentative minimum tax.

### M. CREDIT RECAPTURE

**References** 17053.47(d)(1)(A); 17053.47(d)(1)(B); 17053.47(d)(3);  
23622.8(d)(1)(A); 23622.8 (d)(1)(B); 23622.8 (d)(3)

#### ***Non-Seasonal Employees***

Except as discussed subsequently, recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods:

- The first 270 "days of employment" (whether or not consecutive); or
- Ninety (90) "days of employment" plus 270 calendar days.

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## CALIFORNIA FRANCHISE TAX BOARD

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

### ***Seasonal Employees***

For income or taxable years beginning on or after January 1, 1998, for seasonal employees, the taxpayer must recapture the amount of the credit if employment is terminated before the completion of 270 "days of employment" during the 60-month period beginning the day the employee commences employment with the taxpayer except as subsequently discussed.

To recapture the credit, the taxpayer must add the amount of credit previously claimed in all years to the tax for the tax year that includes the 60<sup>th</sup> month of employment.

A "day of employment" includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

**NOTE:** Any increase in tax, due to credit recapture, cannot be offset by the current year hiring credit.

### ***Credit Recapture – Exceptions***

***References 17053.47(d)(2)(A); 17053.47(d)(2)(B); 23622.8(d)(2)(A); 23622.8(d)(2)(B)***

For both regular and seasonal employees, the credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business; or
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

### ***Change in the Form of the Trade or Business***

***References 17053.47(d)(2)(C); 23622.8(d)(2)(C)***

The employment relationship between the taxpayer and an employee shall not be treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues to be employed in that trade or business and the taxpayer retains a substantial interest in that trade or business,

## **CALIFORNIA FRANCHISE TAX BOARD**

the employee shall not be treated as terminated. In addition, transactions in which IRC Section 381(a) applies will not trigger recapture if the employee continues to be employed by the acquiring corporation.

### **N. RECORD KEEPING REQUIREMENTS**

For each qualified employee, documentation showing:

- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

**CHAPTER 17      LOS ANGELES REVITALIZATION ZONE HIRING CREDIT****A.      INTRODUCTION**

***References (Repealed Sections) 17053.10(a); 17053.10(b)(5); 17053.17(a); 23623.5(a); 23625(a); 23625(b)(5)***

The Los Angeles Revitalization Zone (LARZ) was established to aid economic development in areas that suffered damage during the civil unrest that occurred in the County of Los Angeles during April and May 1992. The LARZ became operative on May 1, 1992, and applied to businesses with taxable or income years beginning on or after January 1, 1992. The LARZ expired on December 1, 1998.

The California Revenue and Taxation Code (CRTC) provided two hiring credit incentives for taxpayers conducting business activities within the LARZ. These incentives are the *General Hiring Credit* and the *Construction Hiring Credit*. In general, these two incentives provide for a credit based upon a declining percentage of qualified wages paid to or incurred for qualified employees.

No new LARZ hiring credits may be generated in taxable or income years beginning on or after January 1, 1998. However, LARZ hiring credit carryovers may still be claimed for 15 years from the year the credit was generated.

- The *General Hiring Credit* is available, for taxable or income years beginning on or after January 1, 1992, and before January 1, 1998, for hiring, on or after May 1, 1992, qualified disadvantaged individuals.
- The *Construction Hiring Credit* is available, for taxable or income years beginning on or after January 1, 1992, and until December 31, 1997, for employing, on or after May 1, 1992, qualified employees. The LARZ *Construction Hiring Credit* requires that the employee be hired to perform construction work within the LARZ. Construction work means any work performed by a qualified employee related directly to the erection, demolition, repair, or renovation of a structure located within the LARZ.

No new LARZ credits may be generated in taxable or income years beginning on or after January 1, 1998. However, LARZ credit carryovers may still be claimed for 15 years from the year the credit was generated.

Taxpayers that receive a LARZ *General Hiring Credit* or *Construction Hiring Credit* in their taxable or income year beginning on or after January 1, 1998, from



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 201 of 307

a 1997 fiscal year pass-through entity *may not* claim these credits in their taxable or income year beginning on or after January 1, 1998. These credits can only be claimed for taxable or income years beginning *before* January 1, 1998.

### ***Geographic Boundaries***

For a listing of cities in the LARZ, refer to Chapter 1, Section (h). To verify an address, refer to Chapter 1, Section (c).

NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) by the Trade and Commerce Agency to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are still allowed to be utilized after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, the hiring credit is no longer available, for income or taxable year beginning on or after 1/1/96 (determination date) for employees hired on or after 1/1/96. For employees hired before 1/1/96, the hiring credit is allowed to be continued for these employees assuming all other qualifying tests are met until expiration of the hiring credit provision.

### **B. TAXPAYER DEFINED – GENERAL & CONSTRUCTION HIRING CREDITS**

***References (Repealed Sections) 17053.10(b)(6); 17053.17(b)(7); 23623.5(b)(7); 23625(b)(6)***

"Taxpayer" means a person or entity engaged in a trade or business within the LARZ.

#### ***Controlled Groups - General Hiring Credit only***

***References (Repealed Sections) 17053.17(b)(9)(A); 23623.5(b)(9)(A); 23623.5(b)(9)(C)***

All employees of trades or businesses that are under common control, or members of the same controlled group, shall be treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC 1563(a) as modified by the California Revenue & Taxation Code, to replace "*at least 80%*" with "*more than 50%*". The determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of IRC Section 1563.

**NOTE:** Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

***Acquired Businesses***

***References (Repealed Sections) 17053.10(c); 17053.17(b)(10); 23623.5(b)(10); 23625(c)***

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues to be employed in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues to be employed in that business.

**NOTE:** The new employer, “steps into the shoes” of the old employer for purposes of incurring future credits.

**C. GENERAL HIRING CREDIT**

**(i.) Qualified Wages**

***References (Repealed Sections) 17053.17(b)(1)-(2); 17053.17(b)(8); 17053.17(d); 23623.5(b)(1)-(2); 23623.5(b)(8)***

*Qualified wages* are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer.

In general, *qualified wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

***Non-Qualified Wages***

Qualified wages *do not* include any wages paid or incurred on or after the LARZ expiration date. The expiration date is the date the LARZ designation expires, is repealed, or becomes inoperative.

***Downsizing of the LARZ***

For taxpayers eliminated from the LARZ geographic area due to the downsizing of the LARZ, the hiring credit can continue to be incurred for qualified employees hired before 1/1/96 (determination date for the downsizing of the LARZ), assuming all other qualifying tests are met, as if the taxpayer still operated within the LARZ geographic area.

***Estates and Trust***

In the case of an estate or trust, the qualified wages shall be apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages have been apportioned, shall be treated as the employer with respect to those wages.

**(ii). Qualified Employee - General Hiring Credit*****References (Repealed Sections) 17053.17(b)(3); 23623.5(b)(3)***

For purposes of the *General Hiring Credit*, a qualified employee is an individual who satisfies all of the following:

**ANNUAL TESTS**

- The employee is a resident of the LARZ;
- At least 90% of the employee's work for the taxpayer, during the taxable or income year, must be directly related to the conduct of the taxpayer's trade or business located within the LARZ;
- At least 50 percent of the employee's services for the taxpayer, during the taxable or income year, must be performed within the boundaries of the LARZ

**NOTE:** If a qualified employee moves out of the LARZ, that employee ceases to be a qualified employee.

**TIME OF HIRE TESTS**

- The employee is hired on or after May 1, 1992.

***Leased Employees***

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer can be identified due to the legal obligation to pay the payroll taxes of the employee, and as to who has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, Employer's Supplemental Tax Guide provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship

***Relocation Into the LARZ***

If a business moves into the LARZ, the employer may claim the hiring credit for qualified wages paid to qualified employees. Such individuals must have been hired on or after May 1, 1992, maintained their residence in the LARZ on the date

## CALIFORNIA FRANCHISE TAX BOARD

they were hired, continued to be LARZ residents when the employer commenced business in the LARZ, and performed services for the employer in the LARZ as required by statute. In regard to the 90% and 50% tests related to employee activity, the first day of the income or taxable year of relocation is used to determine if these percentages are met. Relocation to the LARZ does not affect the percentage ranges of the hiring credit. The percentage ranges relevant to qualified wages begin with the employee's date of hire, not the date the employer commenced business in the LARZ.

### **(iii.) Credit Computation -General Hiring Credit** ***References (Repealed Sections) 17053.17(a); 23623.5(a)***

For each income or taxable year beginning on or after January 1, 1992, and before January 1, 1998, a hiring credit shall be allowed to a qualified taxpayer for hiring a qualified disadvantaged individual (employee) on or after May 1, 1992 for employment within the LARZ. The credit shall be equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit will be used.

***Example:*** An employee was hired 7/1/1996, and the taxpayer is completing the tax return for the year ending 12/31/1997. For the period 1/1/1997 to 6/30/1997, the hiring credit is based on 50% of qualified wages. For the period 7/1/1997 to 12/31/1997, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

***Example:*** An employee is hired 7/1/1996, is temporarily laid off 2/1/1997, and is rehired 4/1/1997. The 50% credit range runs from

7/1/1996 to 6/30/1997 regardless of the layoff period between 2/1/1997 and 3/31/1997.

**(iv.) Reduction for Other Tax Credits – General Hiring Credit**  
***References (Repealed Sections) 17053.17(e); 23623.5(e)***

The LARZ *General Hiring Credit* shall be reduced by the credits allowable under the following California Revenue & Taxation Code Sections:

- 17053.7 & 23621 (Jobs Tax Credit);
- 17053.10 & 23625 – Repealed (LARZ Construction Hiring Credit);
- 17053.74 & 23622.7 (Enterprise Zone Hiring Credit);
- 23623 – Repealed (Program Areas Hiring Credit); and
- The federal credit allowed under IRC Section 51 (Work Opportunity Tax Credit – WOTC).

**D. CONSTRUCTION HIRING CREDIT**

**(i.) Qualified Wages**  
***References (Repealed Sections) 17053.10(b)(1)-(2); 23625(b)(1)-(2)***

*Qualified wages*, for purposes of the LARZ *Construction Hiring Credit*, means that portion of wages paid or incurred, by the taxpayer to its qualified employees for **construction work** in the LARZ during the income or taxable year.

*Qualified wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

***Non-Qualified Wages***

Qualified wages *do not* include any wages incurred after December 31, 1997.

***Downsizing of the LARZ***

For taxpayers eliminated from the LARZ geographic area due to the downsizing of the LARZ, the hiring credit can continue to be incurred for qualified employees hired before 1/1/96 (determination date for the downsizing of the LARZ), assuming all other qualifying tests are met, as if the taxpayer still operated within the LARZ geographic area.

***Estates and Trust***

In the case of an estate or trust, the qualified wages shall be apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages have been apportioned, shall be treated as the employer with respect to those wages.

**(ii.) Qualified Employee-Construction Hiring Credit*****References (Repealed Sections) 17053.10(b)(3); 23625(b)(3)***

For purposes of the *Construction Hiring Credit*, a qualified employee is an individual who satisfies all of the following:

**ANNUAL TESTS**

- The employee is a resident of the LARZ;
- The employee was hired to perform construction work within the LARZ.

**TIME OF HIRE TESTS**

- The employee is hired on or after May 1, 1992.

***Leased Employees***

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer can be identified due to the legal obligation to pay the payroll taxes of the employee, and as to who has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, Employer's Supplemental Tax Guide provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship

***Relocation Into the LARZ***

If a business moves into the LARZ, the employer may claim the hiring credit for qualified wages paid to qualified employees. Such individuals must have been hired on or after May 1, 1992, maintained their residence in the LARZ on the date they were hired, continued to be LARZ residents when the employer commenced business in the LARZ, and performed services for the employer in the LARZ as required by statute. In regard to the 90% and 50% tests related to employee activity, the first day of the income or taxable year of relocation is used to determine if these percentages are met. Relocation to the LARZ does not affect the percentage ranges of the hiring credit. The percentage ranges relevant to

## CALIFORNIA FRANCHISE TAX BOARD

qualified wages begin with the employee's date of hire, not the date the employer commenced business in the LARZ.

### **(iii). Credit Computation-Construction Hiring Credit** ***References (Repealed Sections) 17053.10(a); 23625(a)***

For each income or taxable year beginning on or after January 1, 1992, and before January 1, 1998, a hiring credit shall be allowed to a qualified taxpayer for hiring a qualified employee on or after May 1, 1992 for employment within the LARZ. The credit shall be equal to the sum of each of the following:

- 100% of the qualified wages paid or incurred during the period from May 1, 1992, to the end of the 6<sup>th</sup> full month (June 30, 1993) *after* the designation of the LARZ, for employees that are hired during this period.
- 75% of the qualified wages paid or incurred during the period from the beginning of the 7<sup>th</sup> month (July 1, 1993) *after* designation to the end of the 12<sup>th</sup> full month (December 31, 1993) *after* designation, for employees that are hired during this period.
- 50% of the qualified wages paid or incurred during the period from the beginning of the 13<sup>th</sup> month (January 1, 1994) *after* designation to the end of the 60<sup>th</sup> full month (December 31, 1997) *after* designation, for employees that are hired during this period.

**NOTE:** The LARZ was designated December 31, 1992, operative May 1, 1992.

**Example:** On December 1, 1993, a business hired a qualified employee to perform construction work in the LARZ. The qualified employee worked in the LARZ from December 1, 1993 through June 30, 1994. The qualified employee's hourly wage was \$15.97. The employee was paid for 100 hours during 1993 and 1,000 hours during 1994. The LARZ construction hiring credit for this employee would be computed for 1993 as follows:

$$75\%[\$6.37 \text{ (150\% of minimum wage - not \$15.97)} \times 100] = \$478$$

**Important:** The business would not be able to claim the LARZ construction hiring credit on qualified wages paid to this employee after December 31, 1993 because the designated period within which this employee was hired expired on December 31, 1993. However, such wages may qualify for the LARZ general hiring credit.

### **(iv.) Reduction for Other Tax Credits – Construction Hiring Credit** ***References (Repealed Sections) 17053.10(d); 23625(d)***

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## CALIFORNIA FRANCHISE TAX BOARD

The LARZ *Construction Hiring Credit* shall be reduced by the credits allowable under the following California Revenue & Taxation Code Sections:

- 17053.7 & 23621 (Jobs Tax Credit);
- 17053.8 & 23622 - Repealed (Enterprise Zone Hiring Credit);
- 17053.11 & 23623 - Repealed (Program Areas Hiring Credit);
- 17053.17 & 23623.5 - Repealed (LARZ General Hiring Credit); and
- The federal credit allowed under IRC Section 51 (Work Opportunity Tax Credit - WOTC).

### E. MINIMUM WAGE CHART

EFFECTIVE DATE	MINIMUM WAGE	MAXIMUM HOURLY WAGE - HIRING CREDIT
July 1, 1988 to September 30, 1996	\$4.25	\$6.37 (150% of \$4.25)
October 1, 1996 to February 28, 1997	\$4.75	\$7.12 (150% of \$4.75)
March 1, 1997 to August 31, 1997	\$5.00	\$7.50 (150% of \$5.00)
September 1, 1997 to February 28, 1998	\$5.15	\$7.72 (150% of \$5.15)
March 1, 1998 to Current	\$5.75	\$8.62 (150% of \$5.75)

### F. WAGE EXPENSE DEDUCTION

**References (Repealed Sections) 17053.10(e); 17053.17(e); 23623.5(e); 23625(e)**

The taxpayer must reduce any deduction for wages by the amount of the LARZ hiring credit allowed (including any current year credit to be carried forward).

### G.. BUSINESS INCOME ACTIVITY LIMITATION

**References (Repealed Sections) 17053.10(g)(1)-(2); 17053.17(g)(1)-(2); 23623.5(g)(1)-(2); 23625(g)(1)-(2)**

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## CALIFORNIA FRANCHISE TAX BOARD

The amount of hiring credit or sales or use tax credit or (see Chapter 18) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the LARZ business income in any year. Depending on the tax year involved, the LARZ business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the LARZ. Non-business income or loss is not included in the calculation of business income from the LARZ.

**Example:** Corp. A operates entirely within the LARZ. In order to determine the amount of hiring credit allowable, the business income, and the tax on that business income, must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	\$2,000
Business expenses	<u>(17,000)</u>
Net Taxable Income	\$15,000

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	<u>(17,000)</u>
Net Business Income	\$13,000

To determine the LARZ hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	\$13,000
x 8.84%	<u>x 0.0884</u>
Tax associated with business income	\$1,149

In this example, the taxpayer can offset the tax of \$1,149 with the hiring credit available (up to \$1,149).

**NOTE:** "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

### H. GENERAL PROVISIONS – APPORTIONMENT OF BUSINESS INCOME

**References (Repealed Sections) 17053.10(g); 17053.17(g); 23623.5(g); 23625(g)**

## CALIFORNIA FRANCHISE TAX BOARD

If a business is located within and outside of the LARZ, the taxpayer must determine the portion of the total business income that is attributable to the LARZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, business income is apportioned to the LARZ by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning on or after January 1, 1994, business income shall be apportioned to the LARZ by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

### (i) **Property Factor – Income Apportionment**

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LARZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.
- For income or taxable years beginning on or after January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

### (ii) **Payroll Factor – Income Apportionment**

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the LARZ* during the income or taxable year.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 211 of 307

- For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.
- For income or taxable years beginning on or after January 1, 1994, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.

Example: For the income year ending 12/31/96, Corp. A operates within and outside the LARZ. California business income of \$13,000 needs to be apportioned to the LARZ. The following amounts apply to Corp. A's property and payroll:

LARZ Property	\$40,000
CA Property	\$100,000
LARZ Payroll	\$5,000
CA Payroll	\$10,000

$$\begin{aligned}\text{LARZ Property/CA Property} &= .40 \\ \text{LARZ Payroll/CA Payroll} &= \underline{.50} \\ .90/2 &= .45 \quad \text{LARZ Apportionment Factor}\end{aligned}$$

Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
LARZ Business Income	\$5,850
Current Tax Rate	<u>x .0884</u>
Tax attributable to LARZ business income	\$517

**NOTE:** Had the above example been for an income or taxable year beginning on or after January 1, 1992, and before January 1, 1994, the denominator of the property and payroll factors would have been from worldwide sources rather than CA sources. See Chapter 23, Section (g).

### (iii) Apportionment – Combined Groups

For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994: For members of a combined group, the credit limitation will be based on combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to Chapter 23, Section (g)(iv).

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## CALIFORNIA FRANCHISE TAX BOARD

For income or taxable years beginning on or after 1/1/1994: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the LARZ. The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ property and payroll amounts and the denominator will be based on each LARZ taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/997, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the LARZ. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate LARZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LARZ was determined as follows:

	A	B
<u>Property Factor</u>		
LARZ Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
LARZ Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
Average Apport. %	100%	73.33%
(Property + Payroll Factors)/2		
Apportioned Business Income	\$228,000	\$250,000
LARZ Income	\$228,000	\$183,333

### (iv) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 213 of 307

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within the LARZ and one outside the LARZ. Eighty percent (80%) of the S corporation's business is attributable to the LARZ. (**NOTE:** This percentage was determined by the S corporation, using Worksheet V from the FTB 3806 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the LARZ.

Ray and Mary Smith have the following 1997 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
LARZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The LARZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LARZ income is computed as follows:

Ray's LARZ salary (\$100,000 x 50%)	\$50,000
Mary's LARZ salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp.	
(\$40,000 x 80%)	32,000
LARZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	(1,000)
<b>Total LARZ income</b>	<b>\$151,000</b>

Ray and Mary must compute the tax on the total LARZ income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*; the tax on \$151,000 is \$10,659. The \$10,659 is the first limitation on LARZ credits for the tax year. The second limitation on the credits is the *net tax* on all income.

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## CALIFORNIA FRANCHISE TAX BOARD

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of LARZ income since they are not related to trade or business activities.

### I. S CORPORATIONS

**References** 23803(a)(1)(A); 23803(a)(1)(F); (*Repealed Sections*) 17053.10(e); 17053.17(e); 23623.5(e); (e)

An S corporation's hiring credit may reduce the LARZ tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's LARZ income.

One hundred percent (100%) of the LARZ hiring credits are passed through to the S corporation shareholders. The full amount of the credits are reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

**Example:** An S corporation computes a \$3,000 hiring credit. The S corporation's credit is \$1,000 and the wage reduction is \$1,000. The \$3,000 credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is \$3,000.

### J. CREDIT USAGE & CARRYOVER

The aggregate amount of the LARZ hiring credits and the sales or use tax credit, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the LARZ, determined as if that income represented all of the income of the taxpayer.

The portion of the LARZ credits that exceed the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted, or for 15 years from the year the credit was generated, whichever occurs first.

**Example:** A taxpayer has a \$1,500 LARZ *Sales or Use Tax Credit*, a \$2,400 LARZ *General Hiring Credit* and a \$1,200 LARZ *Construction Hiring Credit*. Tax imposed on LARZ income is \$4,700 and the taxpayer's overall "net tax"/"tax" is

## CALIFORNIA FRANCHISE TAX BOARD

\$4,000. The taxpayer would be eligible to claim \$4,000 maximum in LARZ credits.

Sales or Use Tax Credit	\$ 1,500
General Hiring Credit	2,400
Construction Hiring Credit	<u>1,200</u>
Total LARZ credit	\$5,100
Tax on LARZ income	\$4,700
<b><u>First limitation:</u></b>	
Lesser of total credit or tax on LARZ income	\$4,700
<b><u>Second limitation:</u></b>	
Lesser of tax on LARZ Income or " <i>net tax</i> "/" <i>tax</i> "	\$4,000
Maximum credit allowed:	
Lesser of <i>LARZ tax limitation</i> or " <i>net tax</i> "/" <i>tax</i> " <i>limitation</i>	<u>\$4,000</u>
Total LARZ credit	\$5,100
Maximum credit allowed	<u>\$4,000</u>
Carryover	\$1,100

The LARZ expired on December 1, 1998. If the taxpayer has any unused credits as of this date, the unused credits may continue to be carried forward until they are exhausted, or for 15 years from the year the credit was generated, whichever occurs first. The LARZ will be deemed to remain in existence for purpose of computing the business income limitation.

### K. CREDIT WILL NOT REDUCE CERTAIN TAXES

The LARZ hiring credits cannot reduce the following:

- minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- built-in gains tax (S corporations);
- excess net passive income tax (S corporation); or
- alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries).

For taxable or income years beginning on or after January 1, 1993, the LARZ *Construction Hiring Credit* may reduce the regular tax below the tentative minimum tax.

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 216 of 307

***For taxable or income years beginning on or after January 1, 1994, the LARZ General Hiring Credit may reduce the regular tax below the tentative minimum tax.***

### **L. CREDIT RECAPTURE**

***References (Repealed Sections) 17053.10(h)(1); 17053.17(c)(1); 17053.17(c)(3); 23623.5(c)(1); 23623.5(c)(3); 25625(h)(1)***

Recapture of the hiring credit is required if the employee is terminated at any time during the longer of the following two periods:

- The first 270 days of employment (whether or not consecutive); or
- Ninety (90) days of employment plus 270 calendar days,

A "day of employment" includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

Any increase in tax, due to a credit recapture, cannot be offset by the current year hiring credit.

### ***Credit Recapture – Exceptions***

***References (Repealed Sections) 17053.10(h)(2)(A); 17053.17(c)(2)(A); 23623.5(c)(2)(A); 23625(h)(2)(A)***

The credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business;
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment; or
- For purposes of the Construction Hiring Credit, due to a contractual agreement.

### ***Change in the Form of the Trade or Business***

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 217 of 307

### ***References (Repealed Sections) 17053.10(h)(2)(B); 17053.17(c)(2)(B); 23623.5(c)(2)(B); 23625(h)(2)(B)***

The employment relationship between the taxpayer and an employee shall not be treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues to be employed in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee shall not be treated as terminated. In addition, transactions in which IRC Section 381(a) applies will not trigger recapture if the employee continues to be employed by the acquiring corporation.

## **M. RECORD KEEPING**

For each qualified employee, documentation showing:

- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

### ***Address Verification***

To verify whether or not an employee's address is within the LARZ, check the California Trade & Commerce website, at:

- [www.commerce.ca.gov/business/select/communities/larz/geographicboundaries.html](http://www.commerce.ca.gov/business/select/communities/larz/geographicboundaries.html)

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**CHAPTER 18      LOS ANGELES REVITALIZATION ZONE SALES OR USE  
TAX CREDIT****A.      INTRODUCTION**

***References (Repealed Sections) 17052.15(a); 17052.15(d); 23612.6(a); 23612.6(d)***

The Los Angeles Revitalization Zone (LARZ) was established to aid economic development in areas that suffered damage during the civil unrest that occurred in the County of Los Angeles during April and May 1992. The LARZ became operative on May 1, 1992, and applied to businesses with taxable or income years beginning on or after January 1, 1992. The LARZ expired on December 1, 1998.

- No new LARZ credits may be generated in taxable or income years beginning on or after January 1, 1998. However, LARZ credit carryovers may still be claimed for 15 years from the year the credit was generated.
- Taxpayers that receive a LARZ *Sales or Use Tax Credit* in their taxable or income year beginning on or after January 1, 1998, from a 1997 fiscal year pass-through entity *may not* claim this credit in their taxable or income year beginning on or after January 1, 1998. This credit can only be claimed for taxable or income years beginning *before* January 1, 1998.

***LARZ Locations***

For a listing of LARZ cities, refer to Chapter 1, Section (h). To verify an address, refer to Chapter 1, Section (c).

NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) by the Trade and Commerce Agency to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are still allowed to be utilized after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, the sales or use tax credit is no longer available, as of the first day of the income or taxable year beginning on or after January 1, 1996, the determination date.

***Sales or Use Tax Credit***

***References (Repealed Sections) 17052.15(a)-(b); 23612.6(a)-(b)***

For each income or taxable year beginning on or after January 1, 1992 and before January 1, 1998, a taxpayer engaged in a trade or business within the Los

## CALIFORNIA FRANCHISE TAX BOARD

Angeles Revitalization Zone (LARZ) can take a credit for sales or use tax paid or incurred in connection with the purchase of qualified property.

### **B. EXCLUSIVE CREDIT**

***References (Repealed Sections) 17052.15(c); 23612.6(c)***

If the LARZ sales or use tax credit is claimed for the purchase of qualified property during the income or taxable year, no other credit shall be allowed with respect to that property.

### **C. "TAXPAYER" DEFINED**

***References (Repealed Sections) 17052.15(b)(1); 23612.6(b)(1)***

A "taxpayer" is a person or entity engaged in a trade or business within the LARZ.

#### ***Pass-Through Entities***

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The sales or use tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

### **D. QUALIFIED PROPERTY**

***References (Repealed Sections) 17052.15(b)(2); 23612.6(b)(2)***

Qualified property is property purchased on or after May 1, 1992, and before the zone expiration date. Qualified property is the purchase of either, or both, of the following:

- Building materials to replace or repair the taxpayer's building and fixtures;
- Machinery or equipment, excluding inventory, to be used by the taxpayer exclusively in the LARZ.

#### ***Leased Property***

Taxpayers who acquire property by lease arrangement may qualify for the sales or use tax credit. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the sales or use tax credit. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

### **E. CREDIT COMPUTATION**

***References (Repealed Sections) 17052.15(a); 23612.6(a)***

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## CALIFORNIA FRANCHISE TAX BOARD

The sales or use tax credit is equal to the amount of sales or use tax "paid or incurred" by the taxpayer in connection with the purchase and use of qualified property. Qualified property costs are not limited for LARZ entities.

**Example:** Taxpayer spent \$53,750 to purchase machinery used in the taxpayer's business within the LARZ. The sales tax paid on the purchase is \$3,750. The sales tax credit is \$3,750.

**NOTE:** Upon acquisition, if the taxpayer/purchaser was exempt from paying sales tax on the property under the California Revenue & Taxation Code (CRTC), then the taxpayer/purchaser did not pay or incur sales tax in connection with the purchase of the property to the extent of the exemption. Thus, the taxpayer/purchaser is not allowed to take the sales or use tax credit on the amount of the exemption.

### F. DEPRECIABLE BASIS

**References (Repealed Sections) 17052.15(e); 23612.6(e)**

Any taxpayer that elects to claim the sales or use tax credit, shall *not* increase the basis of the qualified property by the amount of the sales or use tax paid or incurred.

**Example:** Taxpayer spent \$53,750 to purchase machinery used in the taxpayer's business within the LARZ. The sales tax included in the purchase price was \$3,750. The basis of the property is \$50,000 (\$53,750 less \$3,750 sales tax).

### G. BUSINESS INCOME ACTIVITY LIMITATION

**References (Repealed Sections) 17052.15(f)(1)-(2); 23612.6(f)(1)-(2)**

The amount of sales or use tax credit or hiring credit (see Chapter 17) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the LARZ business income in any year. Depending on the tax year involved, the LARZ business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the LARZ. Non-business income or loss is not included in the calculation of business income from the LARZ.

**Example:** Corp. A operates exclusively within the LARZ. In order to determine the amount of sales or use tax credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 221 of 307

---

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	\$2,000
Business expenses	<u>(17,000)</u>
Net Taxable Income	\$15,000

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	<u>(17,000)</u>
Net Business Income	\$13,000

To determine the sales or use tax credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	\$13,000
x 8.84%	<u>x 0.0884</u>
Tax associated with business income	\$1,149

In this example, the taxpayer can offset the tax of \$1,149 with the sales or use tax credit available (up to \$1,149).

**NOTE:** "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

### H. GENERAL PROVISIONS – INCOME APPORTIONMENT

***References (Repealed Sections) 17052.15(f)(1)-(2); 23612.6(f)(1)-(2)***

If a business is located within and outside of the LARZ, the taxpayer must determine the portion of the total business income that is attributable to the LARZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, business income is apportioned to the LARZ by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning on or after January 1, 1994, business income shall be apportioned to the LARZ by multiplying the taxpayer's *California*

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## CALIFORNIA FRANCHISE TAX BOARD

source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

### (i) Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LARZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.
- For income or taxable years beginning on or after January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

### (ii) Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the LARZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.
- For income or taxable years beginning on or after January 1, 1994, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.

Example: For the income year ending 12/31/96, Corp. A operates within and outside the LARZ. California business income of \$13,000 needs to be apportioned to the LARZ. The following amounts apply to Corp. A's property and payroll:

LARZ Property	\$40,000
CA Property	\$100,000
LARZ Payroll	\$5,000
CA Payroll	\$10,000

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 223 of 307

LARZ Property/CA Property	=.40	
LARZ Payroll/CA Payroll	= <u>.50</u>	
	.90/2 = .45	LARZ Apportionment Factor
Business income		\$13,000
Apportionment Factor		<u>x 0.45</u>
LARZ Business Income		\$5,850
Current Tax Rate		<u>x .0884</u>
Tax attributable to LARZ business income		\$517

**NOTE:** Had the above example been for an income or taxable year beginning on or after January 1, 1992, and before January 1, 1994, the denominator of the property and payroll factors would have been from worldwide sources rather than CA sources. See Chapter 23, Section (g).

### (iii) Apportionment – Combined Groups

For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994: For members of a combined group, the credit limitation will be based on combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to Chapter 23, Section (g)(iv).

For income or taxable years beginning on or after 1/1/1994: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the LARZ. The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ property and payroll amounts and the denominator will be based on each LARZ taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/96, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the LARZ. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate LARZ and separate California property and payroll factor amounts are shown below.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 224 of 307

Business income apportioned to the LARZ was determined as follows:

	A	B
<u>Property Factor</u>		
LARZ Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
LARZ Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
Average Apport. %	100%	73.33%
(Property + Payroll Factors)/2		
Apportioned Business Income	\$228,000	\$250,000
LARZ Income	\$228,000	\$183,333

### (iv) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within the LARZ and one outside the LARZ. Eighty percent (80%) of the S corporation's business is attributable to the LARZ. (**NOTE:** This percentage was determined by the S corporation, using Worksheet V from the FTB 3806 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the LARZ.

Ray and Mary Smith have the following 1997 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 225 of 307

---

Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
LARZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The LARZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LARZ income is computed as follows:

Ray's LARZ salary (\$100,000 x 50%)	\$50,000
Mary's LARZ salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. (\$40,000 x 80%)	32,000
LARZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	<u>(1,000)</u>
<b>Total LARZ income</b>	<b>\$151,000</b>

Ray and Mary must compute the tax on the total LARZ income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*; the tax on \$151,000 is \$10,659. The \$10,659 is the first limitation on LARZ credits for the tax year. The second limitation on the credits is the *net tax* on all income.

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of LARZ income since they are not related to trade or business activities.

### I. S CORPORATION & SHAREHOLDER CREDIT AMOUNTS

#### **References 23803(a)**

S corporations operating within the LARZ may claim a credit on the sales or use tax paid or incurred to purchase qualified property during each income or taxable year. An S corporation's sales or use tax credit may reduce the LARZ tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's LARZ income.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 226 of 307

One hundred percent (100%) of the LARZ credits are passed through to the S corporation shareholders. The shareholders claim their pro-rata share of the credit calculated under the California personal income tax law. The Schedules K(100S) and Schedule K-1(100S) must state the credit amounts allocable to the shareholders.

**Example:** Corp. Z, an S corporation, purchases \$2 million of qualified property, and elects to take the LARZ sales or use tax credit. Corp. Z is allowed to claim a sales or use tax credit of \$50,000 ( $\$2,000,000 \times 7.5\% \times 1/3 = \$50,000$ ). [Cost x sales tax rate x 1/3 S corporation credit limitation]

The corporation's two shareholders are each allocated a sales or use tax credit of \$75,000 based on their pro rata share. ( $(\$2,000,000 \times 7.5\%) / 2 = \$75,000$ ). [(Cost x sales tax rate)\* pro rate share (percentage)]

### J. SALES OR USE TAX CREDIT AND THE HIRING CREDIT

**References (Repealed Sections) 17052.15(f)(1); 23612.6(f)(1)**

The amount of credit(s) allowed, in any income or taxable year, when a taxpayer is eligible to take both the sales or use tax credit and the hiring credit, is limited to the amount of tax imposed on the LARZ income. Thus, the taxpayer must aggregate the credits and limit the total amount of credits to tax imposed on the LARZ income.

### K. CREDIT USAGE AND CARRYOVER

**References (Repealed Sections) 17052.15(d); 17052.15(f); 23612.6(d); 23612.6(f)**

The portion of the credit that exceeds the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to the succeeding 15 income or taxable years, or until it is exhausted, whichever occurs first.

The aggregate amount of LARZ credits, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the LARZ, determined as if that income represented all of the income of the taxpayer.

**Example:** A taxpayer has \$4,900 in LARZ credits (sales or use tax credit and hiring credit). Tax imposed on LARZ business income is \$4,700 and the taxpayer's overall "net tax"/"tax" is \$4,000. The maximum amount of credit is

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 227 of 307

limited to the lesser of the tax on the LARZ business income, or the tax on the taxpayer's overall "net tax"/"tax".

Total LARZ credit	\$4,900
Tax on LARZ income	\$4,700
<b><u>First limitation:</u></b>	
Lesser of total credit or tax on LARZ income	\$4,700
<b><u>Second limitation:</u></b>	
Lesser of tax on LARZ income or "net tax"/"tax"	\$4,000
Maximum credit allowed:	
Lesser of <i>LARZ tax limitation</i> or "net tax"/"tax" limitation	<u>\$4,000</u>
Total LARZ credit	\$4,900
Maximum credit allowed	<u>\$4,000</u>
Carryover	\$ 900

The LARZ expired on December 1, 1998. If the taxpayer has any unused credits as of this date, the unused credits may continue to be carried forward until they are exhausted, or for 15 years from the year the credit was generated, whichever occurs first. The LARZ will be deemed to remain in existence for purpose of computing the business income limitation.

### L. CREDIT WILL NOT REDUCE CERTAIN TAXES

The LARZ sales or use tax credit cannot reduce the:

- minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- built-in gains tax (S corporations);
- excess net passive income tax (S corporation);
- alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- regular tax below tentative minimum tax for income or taxable years beginning prior to January 1, 1993.

The LARZ sales or use tax credit may however reduce regular tax below tentative minimum tax for income and taxable years beginning on or after January 1, 1993.

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## CALIFORNIA FRANCHISE TAX BOARD

### **M. DEPRECIATION**

**References 18036; 24916;(Repealed Sections) 17052.15(e); 23612.6(e)**

Taxpayers electing to utilize the sales or use tax credit are not entitled to increase the basis of the property for which sales or use tax was paid or incurred in connection with the purchase of the property.

Depreciation of the capitalized cost of the asset may be claimed using any method of depreciation allowable beginning in the year the asset is placed in service.

**NOTE:** If the business expense deduction is taken for the same property, relevant depreciation will start with the income or taxable year following the year in which the property is placed in service. The depreciation is calculated on the remaining basis *after* reduction for the sales or use tax credit and business expense deduction amounts.

### **N. CREDIT RECAPTURE**

**References (Repealed Sections) 17052.15(g); 23612.6(g)**

Recapture of the LARZ sales or use tax credit is required if the qualified property is disposed of or no longer used by the taxpayer in the LARZ at any time before the close of the second income or taxable year after the property is placed in service. The amount of the credit previously claimed for that property shall be added to the taxpayer's tax liability in the income or taxable year of that disposition or nonuse.

Example: Corp. A purchases property on June 11, 1998 which qualifies Corp. A to take the LARZ sales or use tax credit. Corp. A's income year ends December 31 of each year. Corp. A disposes of the property August 5, 2000. The credit is recaptured in the 2000 tax year as the property was disposed of before the close of the second taxable or income year [12/31/2000] after the property was placed in service.

### **O. RECORD KEEPING REQUIREMENTS**

To support the sales or use tax credit claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- the property purchased (such as serial numbers, etc.);
- the amount of sales or use tax paid or incurred upon purchase; and
- the location where the machinery is used.

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**CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 229 of 307

---

**The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.**

## **CHAPTER 19      LOS ANGELES REVITALIZATION ZONE BUSINESS EXPENSE DEDUCTION**

### **A.      INTRODUCTION**

#### ***References (Repealed Sections) 17266(a); 24356.4(a)***

The Los Angeles Revitalization Zone (LARZ) was established to aid economic development in areas that suffered damage during the civil unrest that occurred in the County of Los Angeles during April and May 1992. The LARZ became operative on May 1, 1992, and applied to businesses with taxable or income years beginning on or after January 1, 1992. The LARZ expired on December 1, 1998.

For income or taxable years beginning on or after January 1, 1992, and prior to January 1, 1998, the law allowed taxpayers, who conducted a trade or business within the Los Angeles Revitalization Zone (LARZ), to elect to treat the cost of qualified property as a business expense rather than a capital item. The deduction was allowed for the income or taxable year in which the property was placed in service.

#### ***LARZ Expiration***

- The LARZ business expense deduction may not be generated in taxable or income years beginning on or after January 1, 1998.
- Taxpayers that receive a LARZ *business expense deduction* in their taxable or income year beginning on or after January 1, 1998, from a 1997 fiscal year pass-through entity *may* claim this deduction in their taxable or income year beginning on or after January 1, 1998.

#### ***LARZ Locations***

For a listing of LARZ cities, refer to Chapter 1, Section (h). To verify an address, refer to Chapter 1, Section (c).

NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) by the Trade and Commerce Agency to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are still allowed to be utilized after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, the business expense deduction is no longer available, as of the first day of the income or taxable year beginning on or after January 1, 1996, the determination date.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 231 of 307

### B. TAXPAYER DEFINED

**References (Repealed Sections) 17266(c)(1); 24356.4(c)(1)**

For purposes of the LARZ business expense deduction, *taxpayer* means a person or entity that conducts a trade or business within the LARZ.

#### ***Pass-Through Entities***

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

#### ***Estates and Trusts***

**References (Repealed Section) 17266(e)**

Estates and trusts are not allowed to take the business expense deduction.

### C. QUALIFIED PROPERTY

**References (Repealed Sections) 17266(c); 17266(g); 24356.4(c); 24356.4(e)**

Qualified property is IRC Section 1245 property (as defined in section 1245(a)(3) of the Internal Revenue Code) purchased and placed in **service on or after September 1, 1992**, for *exclusive use* in a trade or business conducted within the LARZ. The property must also be purchased and placed in service *before* the date the LARZ designation expires, is repealed, or becomes inoperative.

Qualified property under IRC Section 1245 includes, but is not limited to, tangible personal property (excluding buildings and inventory) that is subject to the allowance for depreciation. This includes most equipment and furnishings purchased for exclusive use within the LARZ. Office supplies and other small non-depreciable items are not included.

#### ***Leased Property***

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

### D. PROPERTY NOT QUALIFIED

**References (Repealed Sections) 17266(c); 17266(d); 17266(f); 24356.4(c); 24356.4(d)**

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The business expense deduction will not be allowed if the property:

- was transferred between members of an affiliated group;
- was acquired as a gift or inherited;
- was traded for other property;
- was received from a personal or business relation as defined by IRC Section 267, as modified by 17266(c)(3)(A) and 24356.4(c)(3)(A);
- was received from a personal or business relation as defined by IRC Section 707(b); or
- is described in IRC Section 168(f).

**E. DEDUCTION AMOUNT**

***References (Repealed Sections) 17266; 24356.4***

There are no limitations for the LARZ business expense deduction. The full cost of the qualified property can be expensed. However, the basis of the asset is to be reduced by the expense deduction claimed.

This deduction is available for income or taxable years beginning on or after January 1, 1992 and before January 1, 1998. No deduction is allowed for property purchased after the date the LARZ designation expires, is repealed, or becomes inoperative.

**F. BASIS REDUCTION**

The basis of the asset is to be reduced by the expense deduction claimed.

**G. INTERACTION WITH THE MANUFACTURER'S INVESTMENT CREDIT**

***References 17053.49(b)(1)(C); 23649(b)(1)(C)***

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

**H. ELECTION**

***References (Repealed Sections) 17266(a); 17266(b); 24356.4(a); 24356.4(b)***

The taxpayer must make an election to treat the cost of qualified property as a business expense, on the original return filed for the income or taxable year the



## CALIFORNIA FRANCHISE TAX BOARD

property is first placed in service. The election must specify the items to which the election applies and the cost taken into account for purposes of determining the deduction amount.

The election may not be revoked, unless the taxpayer has obtained the consent of the Franchise Tax Board.

**NOTE:** For the 1992 income or taxable year, a taxpayer could file an amended return to claim the LARZ business expense deduction. The amended return had to be filed no later than June 30, 1994 (see FTB Notice 93-9).

### ***Making the Election***

The election could be made by using:

- [Form FTB 3806](#) - Los Angeles Revitalization Zone Deduction and Credit Summary.

### **I. DEPRECIATION**

***References (Repealed Sections) 17266(a); 24356.4(a)***

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation allowed under IRC Section 179 / CRTC 24356 for the same property.

### **J. CREATING A NET OPERATING LOSS**

Unlike IRC Section 179, there is *no* statutory prohibition on the amount of business expense deduction that may create a net operating loss.

### **K. ALTERNATIVE MINIMUM TAX**

***References 17062; 23457***

The business expense deduction is *not* listed as a tax preference item.

### **L. RECAPTURE**

***References (Repealed Sections) 17266(h); 24356.4(f)***

The business expense deduction is subject to recapture (added back to income) if, before the *close of the second income or taxable year after* the property is placed in service, the property is sold, disposed of, or is no longer used exclusively within the LARZ trade or business.

To recapture the amount deducted, add to the current year income, the amount previously deducted for that property.

## CALIFORNIA FRANCHISE TAX BOARD

**Example:** Corp. A purchases property on June 1, 1995 which qualifies Corp. A to take the LARZ business expense deduction. Corp. A's income year ends December 31 of each year. Corp. A disposes of the property August 5, 1997. The previous deduction is added to income in the 1997 tax year because the property was disposed of before the close of the second income or taxable year after the property was placed in service, 12/31/1997.

### M. CHECKLIST TO DETERMINE ELIGIBILITY FOR THE BUSINESS EXPENSE DEDUCTION

Checklist Items	Yes	No
Is the business qualified? <ul style="list-style-type: none"><li>Is a trade or business conducted within the LARZ? See the <i>Taxpayer Defined</i> section.</li></ul>		
Is the property qualified? <ul style="list-style-type: none"><li>Qualified property is Section 1245 property. See the <i>Qualified Property</i> section.</li><li>Is the property used exclusively within the boundaries of the LARZ?</li></ul>		
Is the correct deduction amount claimed? <ul style="list-style-type: none"><li>Verify purchase on invoices or receipts.</li><li>Verify the date the property is placed in service.</li><li>The deduction is only available for income or taxable years beginning on or after January 1, 1992 and before January 1, 1998.</li></ul>		
Was a timely election made? <ul style="list-style-type: none"><li>Election made on original return?</li><li>Form FTB 3806 – Los Angeles Revitalization Zone Deduction and Credit Summary, or a separate statement attached to the return?</li></ul>		
Was the property acquired through a valid transaction? <ul style="list-style-type: none"><li>See the <i>Property Not Qualified</i> section.</li></ul>		
Were other deductions claimed for the same property? <ul style="list-style-type: none"><li>IRC Section 179 expense may not be claimed for qualified property for which the business expense deduction is claimed.</li></ul>		

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Is the deduction subject to recapture? <ul style="list-style-type: none"><li>• Was the property sold, disposed of or no longer used by the taxpayer in the LARZ, before the close of the second income or taxable year after the property was placed in service?</li><li>• Check current location of the qualified property.</li><li>• Check sale or disposal date of qualified property.</li></ul>		

### N. RECORD KEEPING REQUIREMENTS

To support the business expense deduction claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- the property purchased (such as serial numbers, etc.); and
- the location where the property is used

**CHAPTER 20      LOS ANGELES REVITALIZATION ZONE NET  
OPERATING LOSS****A.      INTRODUCTION**

***References 17276.1(a); 24416.1(a); Repealed Sections 17276.4(a)(1); 24416.4(a)***

The Los Angeles Revitalization Zone (LARZ) was established to aid economic development in areas that suffered damage during the civil unrest that occurred in the County of Los Angeles during April and May 1992. The LARZ became operative on May 1, 1992, and applied to businesses with taxable or income years beginning on or after January 1, 1992. The LARZ expired on December 1, 1998.

Taxpayers are required to annually report their income and expenses. Due to possible fluctuations in income and expenses, a taxpayer may have substantial profits in one year, while losses in another. In years where expenses exceed income, a net operating loss (NOL) occurs.

For entities conducting business within the LARZ, a qualified taxpayer may elect to carry forward 100% of its NOLs for a 15 year period.

A LARZ NOL cannot be generated until the first taxable or income year beginning on or after the area was officially designated the LARZ.

Prior to January 1, 1998, the applicable LARZ NOL code sections were:

- 17276 - 17276.1, 17276.2(b), 17276.3
- 24416 - 24416.1, 24416.2(b), 24416.3

For taxable or income years beginning on or after January 1, 1998, the LARZ NOL code sections are:

- 17276 - 17276.1, 17276.3, 17276.4
- 24416 - 24416.1, 24416.3, 24416.4

The following references in this chapter are to the new code section numbers.

***LARZ Expiration***

- The LARZ NOL may not be generated in taxable or income years beginning on or after January 1, 1998.

## CALIFORNIA FRANCHISE TAX BOARD

- Taxpayers that report an operating loss attributed to the LARZ from a pass through entity, in their taxable or income year beginning on or after January 1, 1998, from a 1997 fiscal year pass-through entity *may not* claim the LARZ NOL in their taxable or income year beginning on or after January 1, 1998. Each taxpayer must determine and elect their own NOL treatment.

### **LARZ Locations**

For a listing of LARZ cities, refer to Chapter 1, Section (h). To verify an address, refer to Chapter 1, Section (c).

NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) by the Trade and Commerce Agency to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are still allowed to be utilized after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, the net operating loss is no longer available, as of the first day of the income or taxable year beginning on or after January 1, 1996, the determination date.

### **B. QUALIFIED TAXPAYER**

***References (Repealed Sections) 17276.4(a); 24416.4(a)***

For purposes of the LARZ NOL, a qualified taxpayer includes a person or entity that is engaged in a trade or business within the LARZ.

Taxpayers doing business in an area that was previously not a qualified area, but later designated as qualified, are allowed to utilize the LARZ NOL for the taxable or income year beginning on or after the date the area is designated as part of the LARZ.

### ***Pass-Through Entities***

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

### **C. ELECTION**

***References 17276.1(a)-(b); 24416.1(a) & (c); Repealed Sections 17276.4(c)-(e); 24416.4(c)-(e)***

Qualified taxpayers must make an election to claim the LARZ NOL. The election must be timely filed with the original return, and be for the income or taxable year in which the NOL is incurred. The election is irrevocable.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 238 of 307

**NOTE:** For LARZ businesses, the election to compute the loss under CRTC 17276.1 or 24416.1 could have been made on an amended return for the 1992 income year only. The amended return had to be filed by June 30, 1994. FTB Notice 94-1, March 18, 1994.

If the taxpayer is eligible to qualify for an NOL under more than one section (operation in more than one economic development area, new small business etc.), the taxpayer must choose which section to elect. Except for the loss incurred under the subdivision elected, taxpayers are prohibited from carrying over any other type of NOL from the same tax year.

Failure to elect to compute the NOL deduction under section 17276.1 or 24416.1 will cause the NOL to be subject to the limitations and restrictions under section 17276 or 24416 (general NOL).

### ***Making the Election***

The election can be made by using:

[Form FTB 3806](#) – Los Angeles Revitalization Zone Deduction and Credit Summary.

In addition, the form FTB 3806 must be filed for each year in which the NOL deduction is taken.

### **D. LARZ NOL COMPUTATION - GENERAL PROVISIONS**

***References 17276.1(a); 24416.1(a); Repealed Sections 17276.4(a)(2); 24416.4(a)(3)***

A LARZ NOL is the loss attributable to the qualified taxpayer's business activities within the LARZ, prior to the LARZ expiration date. LARZ NOLs are determined under IRC Section 172, as modified by the following CRTC Sections:

- 17276.1
- 17276.4
- 24416.1
- 24416.4

### **E. LARZ NOL - LOSS ATTRIBUTED TO BUSINESS ACTIVITY**

***References (Repealed Sections) 17276.4(a)(2); 24416.4(a)(3)***

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## CALIFORNIA FRANCHISE TAX BOARD

A LARZ NOL is the loss attributable to the qualified taxpayer's business activities within the LARZ prior to the LARZ expiration date. Non-business income and/or loss are excluded from the calculation of the LARZ NOL.

If a business is located within and outside of the LARZ, the taxpayer must determine the portion of the total business loss that is attributable to the LARZ.

- Business loss is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For taxpayers conducting business operations within and without the LARZ, business loss is apportioned to the LARZ by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

### (I) Property Factor – Loss Apportionment

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LARZ* during the income or taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

### (ii) Payroll Factor – Loss Apportionment

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the LARZ during the income or taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

**Example** - Two-factor apportionment: For the income year ending 12/31/96, Corp. A operates within and outside an LARZ. Corp. A's business loss of

# CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 240 of 307

\$13,000 needs to be apportioned to the LARZ. The following amounts apply to Corp. A's property and payroll:

LARZ Property	\$40,000
Worldwide (WW) Property	\$100,000
LARZ Payroll	\$5,000
WW Payroll	\$10,000

LARZ Property/WW Property	=.40	
LARZ Payroll/WW Payroll	=.50	
	.90/2 = .45	LARZ Apportionment Factor

Business loss	\$(13,000)
Apportionment Factor	<u>x 0.45</u>
LARZ NOL	\$(5,850)

## (iii) Apportionment – Combined Groups

For members of a combined group, the LARZ NOL calculation will be based on the combined groups worldwide business loss (before CA apportionment). The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

Example: For the income year ending 12/31/96, Parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the LARZ. The combined group operates within and outside California and apportions its income or loss to California using Schedule R. The combined group's business loss is \$1,000,000.

Business loss apportioned to the LARZ was determined as follows:

	A	B	C	Combined
<i>Property Factor</i>				
LARZ Property	\$2,000,000	\$1,000,000	\$0	\$3,000,000
Worldwide Property				\$5,000,000
Apportionment %	40%	20%		60%
<i>Payroll Factor</i>				
LARZ Payroll	\$2,000,000	\$800,000	\$0	\$2,800,000
Worldwide Payroll				\$4,000,000
Apportionment %	50%	20%		70%

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**CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 241 of 307

Average Apport. % (Property + Payroll Factors)/2	45%	20%	65%
Business Loss			\$(1,000,000)
LARZ NOL	\$(450,000)	\$(200,000)	\$(650,000)

**(iv) Apportioning for Personal Income Tax Taxpayers**

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an LARZ and one outside the LARZ. Eighty percent (80%) of the S corporation's business is attributable to the LARZ. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3806 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the LARZ.

Ray and Mary Smith have the following 1997 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary Loss	200,000
LARZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The LARZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LARZ loss is computed as follows:

Ray's LARZ salary (\$100,000 x 50%)	\$50,000
Mary's LARZ salary (\$75,000 x 100%)	75,000

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 242 of 307

Pass-through ordinary loss from the S-Corp.	
(\$200,000 x 80%)	(160,000)
LARZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	<u>(1,000)</u>
Total LARZ loss	<u>\$(41,000)</u>

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of LARZ NOL since they are not related to trade or business activities.

### F. LARZ NOL LIMITED BY GENERAL NOL

**References 17276; 24416**

The LARZ NOL is compared to the NOL computed under the general NOL provisions of section 17276 / 24416, *prior to the 50% reduction*. The LARZ NOL carryover is limited to the lesser of the LARZ NOL or the general NOL (prior to the 50% reduction). NOTE: If the LARZ NOL is limited by the general NOL amount, (prior to the 50% reduction), the amount can still be characterized as an LARZ NOL and allowed to be carried over at 100% for 15 years. An election must be made to characterize the NOL as an LARZ NOL.

**Example:** Corp. B incurred the following loss:

Income from business operations	\$160,000
Interest from investment which is unrelated to Corp. B's business operations	15,000
Expenses of business operations	<u>(189,000)</u>
<b>Net loss</b>	<b><u>(\$14,000)</u></b>

To determine the NOL carryover attributed to the LARZ business operations, the following must be done:

1. Determine NOL per CRTC 24416 (prior to 50% reduction)
2. Determine NOL per CRTC 24416.4 (remove non-business items)

The NOL carryover is limited to the lesser of item 1 or item 2 above.

1. CRTC 24416 "general" NOL - prior to 50% reduction  
Net loss of Corp. B (\$14,000)
2. CRTC 24416.2 LARZ NOL - exclude non-business income/loss  
Income from operations \$160,000

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## CALIFORNIA FRANCHISE TAX BOARD

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Expenses of operations	(189,000)
Net loss of Corp. B (LARZ)	(\$29,000)

Pattern 1: Assume Corp. B operates entirely within the LARZ. Corp. B is allowed to carry over the lesser of the "general" NOL, or the LARZ NOL; in this case \$14,000.

Pattern 2: Assume Corp. B conducts 40% of its total business operations in the LARZ, as discussed in Section (e). Because Corp. B only has 40% of its business operation in the LARZ, the \$29,000 business loss must be apportioned before comparing it to the "general" NOL. In this example, the LARZ loss is \$11,600 (\$29,000 x 40%). Corp. B is allowed to carry over the lesser of the "general" NOL, or the LARZ NOL; in this case, \$11,600.

### G. CARRYOVER / CARRYBACK

**References 17276.1(a); 24416.1(a); Repealed Sections 17276.4(a)(1); 17276.4(a)(4); 24416.4(a)(1); 24416.4(a)(2); 24416.4(a)(5)**

For each income or taxable year a qualified taxpayer engaged in a trade or business within the designated LARZ may elect to carryover 100% of its NOL. No NOL carrybacks are allowed.

The NOLs may be carried over to each of the 15 income or taxable years following the year of loss, or until exhausted, whichever occurs first. If an NOL carryover remains after the LARZ designation has expired, or for taxpayers operating in the portion of the LARZ that was eliminated during the downsizing, the LARZ shall be deemed to remain in existence for purposes of computing the LARZ income limitation, and for purposes of allowing the LARZ NOL deduction.

**NOTE:** Financial institutions, as defined in IRC Sections 585, 586, or 593, using bad debt reserve methods may carry the loss forward for a maximum of 5 income years.

### H. LARZ NOL DEDUCTION - GENERAL PROVISIONS

**References (Repealed Sections) 17276.4(a)(3); 17276.4(a)(4); 24416.4(a)(4); 24416.4(a)(5)**

The LARZ NOL deduction can only offset business income attributable to operations of the taxpayer within the designated LARZ.

In the event a LARZ NOL deduction is allowable for any taxable or income year after the LARZ designation has expired, or for taxpayers operating in the portion of the LARZ that was eliminated during the downsizing, the LARZ will be deemed

## CALIFORNIA FRANCHISE TAX BOARD

to remain in existence for the purpose of computing the business income limitation and allowing an NOL deduction.

### (i) Income Attributed to Business Activity

***References (Repealed Sections) 17276.4(a)(5); 17276.4(a)(5)(A); 24416.4(a)(6); 24416.4(a)(6)(A)***

If a business is located within and outside of the LARZ, the taxpayer must determine the portion of the total business income that is attributable to the LARZ.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1994, business income shall be apportioned to the LARZ by multiplying the taxpayer's total California source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning on or after January 1, 1992, and before January 1, 1994, business income is apportioned to the LARZ by multiplying the worldwide business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

### (ii) Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the LARZ* during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the income or taxable year *within California*.
- For income or taxable years beginning before January 1, 1994, the denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

## CALIFORNIA FRANCHISE TAX BOARD

### (iii) Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the LARZ during the income or taxable year.

- For income or taxable years beginning on or after January 1, 1994, the denominator is the total compensation paid to employees working for the taxpayer *in California* during the income or taxable year.
- For income or taxable years beginning before January 1, 1994, the denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

**Example** - Two-factor apportionment: For the income year ending 12/31/97, Corp. A operates within and outside an LARZ. California business income of \$13,000 needs to be apportioned to the LARZ. The following amounts apply to Corp. A's property and payroll:

LARZ Property	\$40,000	
CA Property	\$100,000	
LARZ Payroll	\$5,000	
CA Payroll	\$10,000	
LARZ Property/CA Property	= .40	
LARZ Payroll/CA Payroll	= <u>.50</u>	
	.90/2 = .45	LARZ Apportionment Factor
Business income	\$13,000	
Apportionment Factor	<u>x 0.45</u>	
LARZ Business Income	\$5,850	

### (iv) Apportionment – Combined Groups

For income or taxable years beginning before January 1, 1994: For members of a combined group, the income limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ payroll and property amounts, and the denominator will be based on the combined groups worldwide payroll and property amounts.

For an example of apportionment under this method refer to Chapter 23, Section (g)(iv).

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## CALIFORNIA FRANCHISE TAX BOARD

For income or taxable years beginning on or after 1/1/1994: For members of a combined group, the limitation will be based on the intrastate apportioned business income for each taxpayer doing business within the LARZ. The numerator of the apportionment formula will be based on each LARZ taxpayer's separate LARZ property and payroll amounts and the denominator will be based on each LARZ taxpayer's separate California property and payroll amounts.

**Example:** For the income year ending 12/31/97, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the LARZ. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate LARZ and separate California property and payroll factor amounts are shown below.

Business income apportioned to the LARZ was determined as follows:

	A	B
<u>Property Factor</u>		
LARZ Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
<u>Payroll Factor</u>		
LARZ Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
Average Apport. %	100%	73.33%
(Property + Payroll Factors)/2		
Apportioned Business Income	\$228,000	\$250,000
LARZ Income	\$228,000	\$183,333

### (v) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 247 of 307

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an LARZ and one outside the LARZ. Eighty percent (80%) of the S corporation's business is attributable to the LARZ. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3806 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the LARZ.

Ray and Mary Smith have the following 1997 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
LARZ business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The LARZ business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's LARZ income is computed as follows:

Ray's LARZ salary (\$100,000 x 50%)	\$50,000
Mary's LARZ salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. (\$40,000 x 80%)	32,000
LARZ business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	<u>(1,000)</u>
Total LARZ income	\$151,000

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of LARZ income since they are not related to trade or business activities

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 248 of 307

### **I. NOL SUSPENSIONS**

***References 17276.3(c); 24416.3(c)***

NOLs incurred by qualified taxpayers are *not* suspended for taxable or income years beginning in 1991 and 1992.

### **J. S CORPORATIONS**

***References 23802(d)(1)-(2)***

For qualified taxpayers electing S corporation status *after* the designation of the LARZ, the qualified NOL attributed to the C corporation years cannot offset S corporation net income.

### **K. ALTERNATIVE MINIMUM TAX**

***References 17062; 23456***

Taxpayers claiming an LARZ NOL deduction must also determine their NOL for alternative minimum tax purposes.

### **L. FLOW-THROUGH LOSSES**

***References 17087.5; 17087.6; 17851; 23800; 24271***

The income and loss that will flow through to a shareholder, beneficiary, partner, or member, retains the same characteristics as it had with the pass-through entity.

The election (Section C) to claim an NOL must be made by the entity and each investor on their respective returns. The election by the entity to utilize the LARZ NOL does not extend to, or bind the investor to utilizing the LARZ NOL. Further, the investor may utilize the LARZ NOL if the entity utilized the general NOL provisions, or had no NOL. Each taxpayer must determine if they in fact have a NOL, and then decide whether the general or LARZ NOL will be utilized.



**CHAPTER 21      LOS ANGELES REVITALIZATION ZONE NET INTEREST DEDUCTION****A.      INTRODUCTION*****References (Repealed Sections) 17233; 24385***

The Los Angeles Revitalization Zone (LARZ) was established to aid economic development in areas that suffered damage during the civil unrest that occurred in the County of Los Angeles during April and May 1992. The LARZ became operative on May 1, 1992, and applied to businesses with taxable or income years beginning on or after January 1, 1992. The LARZ expired on December 1, 1998.

California Revenue & Taxation Code (CRTC) Sections 17233 and 24385 provide for the deduction of net interest income for loans made to a trade or business located solely within the LARZ. The net interest deduction is for interest payments received in income or taxable years beginning on or after January 1, 1992, and after May 1, 1992, and on or before November 30, 1998, whether a calendar or fiscal year taxpayer.

***Geographic Boundaries***

For a listing of cities in the LARZ, refer to Chapter 1, Section (h). To verify an address, refer to Chapter 1, Section (c).

NOTE: Effective 1/1/96, the LARZ geographic area was re-determined (downsized) by the Trade and Commerce Agency to eliminate previously qualified addresses. For taxpayers that operate in the portion of the LARZ that was excluded when the LARZ was downsized, LARZ benefits that were incurred when the LARZ designation was effective are still allowed to be utilized after downsizing (carryover amounts). In regards to the applicability of LARZ benefits incurred after the downsize of the LARZ, the net interest deduction is no longer available, as of the first day of the income or taxable year beginning on or after January 1, 1996, the determination date.

**B.      QUALIFIED TAXPAYER*****References (Repealed Sections) 17233(a); 24385(a)***

For purposes of the LARZ net interest deduction, a qualified taxpayer includes a person or entity (creditor) that loans funds on or after 5/1/92, to a qualified business/debtor and receives interest payments thereon. The loan advanced to

the qualified business/debtor must also meet the requirements as discussed in Section (c).

The creditor does not have to be located in the LARZ to take advantage of the net interest deduction. Only the debtor needs to operate in the LARZ.

***Pass-Through Entities***

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

**C. QUALIFIED DEBT**

***References (Repealed Sections) 17233(b); 24385(b)***

To claim the net interest deduction for creditors, the following requirements must be met at the time the indebtedness is incurred:

- The trade or business (qualified business/debtor) to which the loan is made, must be located solely within the LARZ;
- The indebtedness is incurred solely in connection with activity within the LARZ; and
- The creditor has no equity or other ownership interest in the debtor.

**NOTE:** Repealed Sections 17233(b)(3) & 24385(b)(3) require that the creditor have no equity or other ownership interest in the debtor at the time the loan is made. However, the CRTC does not provide for any limitation after the loan is made. For example, assume that two years after the qualified loan is made the debtor contacts the creditor to renegotiate the loan terms due to the debtor's poor financial condition. The creditor agrees to take an equity interest in the debtor in exchange for reducing the amount due from the debtor. Net interest received from the remaining portion of the qualified loan would still be deductible.

To claim the net interest deduction for creditors, the following requirements must be met annually:

- The qualified business/debtor that the loan was made to and interest payments are received from, must be conducting business in the LARZ.

***Example: Two years after the qualified loan is funded, the qualified business/debtor moves their operations entirely outside of the LARZ geographic boundaries. The net interest deduction is no longer allowed because the trade or business is not located within the designated LARZ.***

***Security/Collateral***

The statute does not require that the security or collateral for the loan be located in the LARZ. For example, a sole proprietor can use its personal residence as collateral for the LARZ business loan and the creditor would still be allowed the net interest deduction assuming all other qualifications are met.

***Definition of "Qualified Business/Debtor"***

The definition of a *qualified business/debtor* in Section 7102 of the Government Code requires inquiry at the entity level. The business activity of the entity (entirely or a portion thereof as relevant) must be conducted within the LARZ.

***Definition of a "Trade or Business"***

Black's Law Dictionary defines *trade or business* as follows:

*"Any business or professional activity conducted by a taxpayer, the objective of which is to earn a profit. The general test for determining whether a person is engaged in "trade or business" so as to be entitled to deduct expenses as trade or business expenses under the Internal Revenue Code is whether the taxpayer's primary purpose and intention in engaging in the activity are to make a profit."*

***Definition of "Located Solely Within"***

***References (Repealed Sections) 17233(b)(1); 24385(b)(1)***

In order to claim the net interest deduction, the loan must be made to a qualified business/debtor *located solely within* the LARZ. Generally, one looks to the presence of tangible property in order to determine the place, site, or limits of a business. Intangible property by definition cannot be located by reference to physical presence. The presence of all of the qualified trade or business' payroll and tangible property within the LARZ would be a strong indication that they meet the test. The fact that sales are delivered by common carrier outside of the LARZ should not cause the debtor to fail the "*located solely within*" requirement.

**D. NET INTEREST DEDUCTION – COMPUTATION**

***Net Interest***

For purposes of determining the net interest deduction, *net interest* is gross interest received less related interest expense (cost of funds) and any other directly related expenses.

***Gross Interest***

## CALIFORNIA FRANCHISE TAX BOARD

There may be substantial differences between tax and book accounting methods. Consequently, the amount of gross interest income included in the computation of net interest must be determined using the creditor's tax accounting method (i.e., the gross interest income included in the computation of net interest corresponds to the gross interest income included in the determination of taxable income). Gross interest income should not include items that are not in the nature of interest.

Interest is defined as an amount paid for the use or forbearance of money.

Gross interest may be determined by referencing the loan contract. A contract between a creditor and a qualified business/debtor may include all of the following:

- A stated rate of interest;
- Points;
- Commitment fees (fees for entering into an agreement that obligates the lender to make funds available for an agreed period at a stated rate of interest - see Rev. Rul. 70-540)\*;
- Service fees (fee charged for processing a loan); and
- Escrow interest.

Analysis of each of the above items is necessary to determine which are in the nature of interest. For example, commitment fees and service fees should not be included in gross interest for purposes of determining the net interest deduction as they are fees earned when establishing the loan and are not monies paid for the use of the loaned funds.

Points are a charge by the lender, in addition to the stated rate of interest, to reflect the actual cost of borrowing money. Thus, points as here described, are for the use or forbearance of money and are considered to be interest. Escrow interest is interest from the date the loan is funded until 30 days before the borrower's first loan payment. Original issue discount (OID) is another form of interest. Stated interest, points, escrow interest, and OID are all items that may be included in gross interest for purposes of determining the net interest deduction.

**\*NOTE:** Revenue Ruling 70-540, 1970-2 CB 101 discusses the character of commitment fees from the lender's point of view. The commitment fee is a charge for agreeing to make funds available rather than for the use or forbearance of money, and therefore, is not interest. Other revenue rulings discuss commitment fees from the point of view of the borrower. To the extent of any discussion

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 253 of 307

concerning the treatment of points by the lender, Rev. Rul. 70-540 was made obsolete by Rev. Proc. 94-29, 1994-1 CB 616; this does not effect its relevance in regards to commitment fees.

### ***Cost of Funds***

A reasonable amount of interest expense must be assigned to the interest income. One method of determining a reasonable cost of funds would be the following formula:

$$\frac{\text{Interest Expense}}{\text{Funding Sources}} = \text{Cost of Funds}$$

Funding sources are equal to average liabilities plus owners' equity less average non-interest earning assets.

The ratio from the above formula would be multiplied by the average loan principal outstanding for the year. All amounts should be on a tax basis.

For example, assume the following is from the tax return of a financial institution:

Average liabilities and owners' equity	\$53,000,000,000	
LESS: Average non-interest earning assets	<u>7,000,000,000</u>	
Funding Sources	\$46,000,000,000	
 Total Interest Expense	 <u>\$1,500,000,000</u>	
Funding Sources	\$46,000,000,000	= 3.26%

Assume that an average principal amount of \$10 million was outstanding during the year for loans made to businesses within the LARZ. A reasonable amount of interest expense to assign to the loans is \$326,000 (\$10 million times 3.26%).

Taxpayers may also use an independent cost of funds index such as the prime index rate or the London Interbank Offered Rate (LIBOR), which is the rate banks use to place Eurodollars with one another in London. If an independent index is used, that index must approximate the taxpayer's cost of funds.

The annual report of many banks or savings and loan associations provides the average cost of funds. The net interest margin (the difference between interest income and interest expense) is usually of interest to shareholders and other

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users of the annual report. The net interest margin should be similar to that used for the calculation of the net interest deduction.

***Other Related Expenses***

"Net interest" is interest received less the cost of funds and direct expenses incurred in earning such interest. An example of a direct expense is commission paid to a loan representative. Expenses that are not directly attributable to the loan in question should not be subtracted for purposes of determining the net interest deduction.

All reasonably identifiable direct costs applicable to acquiring or making a loan should be capitalized and written off over the life of the loan. The amortization method should reflect the nature of the loan. It would be reasonable to use straight line or principal reduction methods of amortization (see Rev. Proc. 94-29 for application of the principal reduction method).

***Non-Bank & Non-Financial Lenders***

Non-financial corporations and individuals usually do not have all of the various income and expense items referred to previously.

Generally, gross interest of non-bank or non-financial creditors will be the interest income as stated in the loan. For example, an individual creditor will generally avoid escrow interest by establishing the monthly due date of the loan as the day of the month the loan was funded, or the day escrow closed, whereas mortgages carried by a commercial lender generally have a common due date, i.e., the beginning of the month.

Related expenses, such as the cost of funds, must be determined in order to compute the deduction of net interest income. Non-bank or non-financial lenders who make loans to qualified businesses located solely within the LARZ may incur investment interest expense related to such loans. The interest tracing rules under Treas. Reg. 1.163-8T are appropriate for determining related interest expense for these taxpayers.

**E. EXPIRATION OF LARZ DESIGNATION*****References 17233; 24385***

Once the LARZ designation expires, becomes inoperative, or ceases to exist, the net interest deduction is not allowed because the trade or business is no longer located within the designated LARZ.

**F. RECORD KEEPING**

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 255 of 307

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The qualified taxpayer/creditor should maintain records on each loan (loan agreements) for which a deduction of net interest has been taken that identifies or describes:

- the debtor,
- the debtor's location (at the time of indebtedness and annually),
- the debtor's mailing address,
- the purpose/use of the loan,
- the stated interest,
- other items included in gross interest,
- any direct expenses associated with the loan, and
- any property securing the loan.

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## **CHAPTER 22      PROGRAM AREA HIRING CREDIT**

### **A.      INTRODUCTION**

***References (Repealed Sections) 17053.11; 23623***

Program Areas converted to enterprise zones as of January 1, 1997. Prior to this date, taxpayers had to be certified by the California Trade and Commerce Agency (TCA) in order to be eligible to utilize the Program Area tax incentives. TCA could certify a taxpayer to take the hiring credit only or all five Program Area incentives. The type of certification can be determined from the certification letter.

Certification was generally valid for three years. After three years, the taxpayer would have to be re-certified. De-certification could occur if a company failed to meet the requirements.

The Program Area hiring credit applies to those employees hired after the designation date of the Program Area. No credit may be claimed for employees hired after the Program Area designation expires. However, for income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs (refer to Chapter 2).

The following Program Area discussion relates to income and taxable years beginning prior to January 1, 1997.

#### ***Geographic Boundaries***

For a listing of program areas, refer to Chapter 1, Section (i). To verify an address, refer to Chapter 1, Section (c).

### **B.      QUALIFIED BUSINESS**

***References (Repealed Sections) 17053.11(b)(1); 23623(b)(1)***

To be a "qualified business" *eligible for all five* of the Program Area tax incentives, a business must be certified during the income or taxable year by the Trade and Commerce Agency as meeting one of the following standards based on its *total work force* in the Program Area:

- 50% of its Program Area work force must be residents of a high density unemployment area (HDUA); or
- 30% of its Program Area work force must be residents of a HDUA and the company must contribute to an approved community service program;



## CALIFORNIA FRANCHISE TAX BOARD

The business may also qualify if persons owning at least 30% of the business are residents of a HDUA.

To be a "qualified business" *eligible for the hiring credit only*, a business must be certified during the income or taxable year by the Trade and Commerce Agency as meeting one of the following standards *based ONLY on those employees hired by the business in the Program Area within the 12 months period immediately preceding the date certification is sought*:

- 50% of its Program Area work force must be residents of a high density unemployment area (HDUA); or
- 30% of its Program Area work force must be residents of a HDUA and the company must contribute to an approved community service program;

The business may also qualify if persons owning at least 30% of the business are residents of a HDUA.

### C. QUALIFIED WAGES

***References (Repealed Sections) 17053.11(e); 23623(e)***

*Qualified wages* are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer.

In general, *qualified wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

### ***Estates and Trust***

In the case of an estate or trust, the qualified wages shall be apportioned between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages have been apportioned, shall be treated as the employer with respect to those wages.

### ***Minimum Wage Chart***

EFFECTIVE DATE	MINIMUM WAGE	MAXIMUM HOURLY WAGE - HIRING CREDIT
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The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

July 1, 1988 to September 30, 1996	\$4.25	\$6.37 (150% of \$4.25)
October 1, 1996 to February 28, 1997	\$4.75	\$7.12 (150% of \$4.75)
March 1, 1997 to August 31, 1997	\$5.00	\$7.50 (150% of \$5.00)
September 1, 1997 to February 28, 1998	\$5.15	\$7.72 (150% of \$5.15)

### D. QUALIFIED EMPLOYEE

**References (Repealed Sections) 17053.11(b)(2); 17053.11(c); 17053.11(d); 23623(b)(2); 23623(c); 23623(d)**

A *qualified employee* is an individual who has been an unemployed resident of a HDUA, for three or more months prior to being employed by the qualified business. Participation by a prospective employee in a state or federally funded job training or work demonstration program does not constitute employment, or affect the eligibility of an otherwise qualified employee.

A *qualified employee* also includes an otherwise qualified individual who is employed by a qualified business in the 90 days prior to the business' certification by the TCA.

#### **Leased Employees**

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer can be identified due to the legal obligation to pay the payroll taxes of the employee, and as to who has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, *Employer's Supplemental Tax Guide* provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship.

### E. CREDIT COMPUTATION

**References (Repealed Sections) 17053.11(a); 17053.11(c) & (d); 23623(a); 23623(c) & (d)**

For each income or taxable year a hiring credit shall be allowed to a qualified business for hiring a qualified employee who has been unemployed for *at least six (6) months*. The credit shall be equal to the sum of each of the following:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

For those qualified employees who have been unemployed for at least three (3) months but less than six (6) months, the credit shall be equal to the sum of the following:

- 25% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit will be used.

**Example:** An employee was hired 7/1/1995, and the taxpayer is completing the tax return for the year ending 12/31/1996. For the period 1/1/1996 to 6/30/1996, the hiring credit is based on 50% of qualified wages. For the period 7/1/1996 to 12/31/1996, the hiring credit is based on 40% of qualified wages.

Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

**Example:** An employee is hired 7/1/1995, is temporarily laid off 2/1/1996, and is rehired 4/1/1996. The 50% credit range runs from 7/1/1995 to 6/30/1996 regardless of the layoff period between 2/1/1996 and 3/31/1996.

### **Reduction for Other Tax Credits**

#### **References (Repealed Sections) 17053.11(h); 23623(g)**

The Program Area hiring credit shall be reduced by the credit allowed under California Revenue & Taxation Code Section 17053.7 & 23621 (Jobs Tax Credit),

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 260 of 307

and the federal credit allowed under IRC Section 51 (Work Opportunity Tax Credit – WOTC).

### F. WAGE EXPENSE DEDUCTION

***References (Repealed Sections) 17053.11(h); 23623(g)***

The taxpayer must reduce any deduction for wages by the amount of the Program Area hiring credit allowed (including any current year credit to be carried forward).

### G. BUSINESS INCOME ACTIVITY LIMITATION

***References (Repealed Sections) 17053.11(j); 23623(i)***

The amount of hiring credit or sales or use tax credit (see Chapter 23) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's Program Area business income in any year. The Program Area business income is that portion of *worldwide* business income that is apportioned to the Program Area. Non-business income or loss is not included in the calculation of business income from the Program Area. Each taxpayer claiming the credit must compute the Program Area business income and resulting tax.

Example: Corp. A operates entirely within a Program Area. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	2,000
Business expenses	<u>(17,000)</u>
Net taxable income before taxes	\$15,000

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	<u>(17,000)</u>
Net Business Income	\$13,000

To determine the Program Area hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	\$13,000
x 9.3%	<u>.093</u>

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

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Tax associated with business income	\$1,209
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In this example, the taxpayer can offset the tax of \$1,209 with the hiring credit available (up to \$1,209).

**NOTE:** "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

### **H. GENERAL PROVISIONS – APPORTIONMENT OF BUSINESS INCOME** ***References (Repealed Sections) 17053.11(j)(2); 23623(i)(2)***

If a business is located within and outside of a Program Area, or in more than one Program Area, the taxpayer must determine the portion of the total business income that is attributable to each Program Area.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991- 1995 years and 1996 calendar year taxpayers), business income is apportioned to the Program Area by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For 1996 fiscal years, income or loss attributed to the Program Area is determined by multiplying *worldwide* business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor (double weighted), the denominator of which is four (4).

For income or taxable years beginning before January 1, 1991, income or loss attributed to the Program Area is determined by multiplying *worldwide* business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

#### **(i) Property Factor – Income Apportionment** ***References (Repealed Sections) 17052.13(f) 23612(f)***

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the Program Area* during the income or taxable year. The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 262 of 307

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

### (ii) Payroll Factor – Income Apportionment

#### **References (Repealed Sections) 17052.13(f) 23612(f)**

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the Program Area* during the income or taxable year. The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

### (iii) Sales Factor – Income Apportionment

The sales factor is a fraction. The numerator of the sales factor is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayers trade or business in the PA. The denominator is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

**Example:** For the income year ending 12/31/95, Corp. A operates within and outside a Program Area. Total business income of \$13,000 needs to be apportioned to the Program Area. The following amounts apply to Corp. A's property and payroll:

Program Area Property	\$40,000	
WW Property	\$100,000	
Program Area Payroll	\$5,000	
WW Payroll	\$10,000	
Program Area Property/WW Property	=.40	
Program Area Payroll/WW Payroll	= <u>.50</u>	
	.90/2 = .45	Program Area Apportionment Factor
Business income	\$13,000	
Apportionment Factor	<u>x 0.45</u>	
Program Area Business Income	\$5,850	

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

**CALIFORNIA FRANCHISE TAX BOARD**

Current Tax Rate (Prior to 1997 – 9.3%)	<u>x 0.093</u>
Tax attributable to Program Area business income	\$544

**(iv) Apportionment – Combined Groups**

For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each Program Area taxpayer's separate Program Area payroll and property amounts (and sales as discussed in (g)) and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in (g)).

Example: For the income year ending 12/31/95, Parent corporation A has two subsidiaries, B and C. Corporations A and B operate within a Program Area. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income is \$1,000,000.

Business income apportioned to the Program Area was determined as follows:

	A	B	C	Combined
<u>Property Factor</u>				
Program Area	\$2,000,000	\$1,000,000	\$0	\$3,000,000
Worldwide Property				\$5,000,000
Apportionment %	40%	20%		60%
<u>Payroll Factor</u>				
Program Area	\$2,000,000	\$800,000	\$0	\$2,800,000
Worldwide Payroll				\$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Income				\$1,000,000
Program Area	\$450,000	\$200,000		\$650,000
Income				

**(v) Apportioning for Personal Income Tax Taxpayers**

The following examples show the application of the apportioning rules to personal income tax taxpayers.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 264 of 307

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within a Program Area and one outside the Program Area. Eighty percent (80%) of the S corporation's business is attributable to the Program Area.

(NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the Program Area.

Ray and Mary Smith have the following 1996 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
Program Area business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The Program Area business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's Program Area income is computed as follows:

Ray's Program Area salary (\$100,000 x 50%)	\$50,000
Mary's Program Area salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. (\$40,000 x 80%)	32,000
Program Area business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	<u>(1,000)</u>
Total Program Area income	\$151,000

Ray and Mary must compute the tax on the total Program Area income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*, the 1996 tax on \$151,000 is \$10,938. The

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## CALIFORNIA FRANCHISE TAX BOARD

\$10,938 is the first limitation on Program Area credits for the 1996 tax year. The second limitation on the credits is the *net tax* on all income.

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of Program Area income since they are not related to trade or business activities.

### I. S CORPORATIONS

**References** 23803(a)(1)(A); 23803(a)(1)(F)

An S corporation's hiring credit may reduce the Program Area tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's Program Area income.

One hundred percent (100%) of the Program Area credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

**Example:** An S corporation computes a \$3,000 hiring credit. The S corporation's credit is \$1,000 and the wage reduction is \$1,000. The \$3,000 credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is \$3,000.

### J. CREDIT USAGE & CARRYOVER

**References (Repealed Sections)** 17053.11(i); 17053.11(j)(1); 17053.11(j)(3); 23623(h); 23623(i)(1); 23623(i)(3)

The total amount of Program Area hiring and sales or use tax credits, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the Program Area, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 266 of 307

**Example:** A taxpayer has a \$4,900 Program Area hiring credit. Tax imposed on Program Area business income is \$4,700 and the taxpayer's overall "net tax"/"tax" is \$4,000. The taxpayer would be eligible to claim a \$4,000 maximum hiring credit.

Total hiring credit	\$4,900
Tax on Program Area income	\$4,700
<b>First limitation:</b>	
Lesser of total credit or tax on Program Area income	\$4,700
<b>Second limitation:</b>	
Lesser of tax on Program Area income or "net tax"/"tax"	\$4,000
Maximum credit allowed:	
Lesser of <i>Program Area tax limitation</i> or " <i>net tax</i> "/" <i>tax</i> " limitation	<u>\$4,000</u>
Total hiring credit	\$4,900
Maximum credit allowed	<u>\$4,000</u>
Carryover	\$ 900

### K. CREDIT WILL NOT REDUCE CERTAIN TAXES

The Program Area hiring credit cannot reduce the:

- minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- built-in gains tax (S corporations);
- excess net passive income tax (S corporation);
- alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- regular tax below tentative minimum tax (TMT) before January 1, 1993

**NOTE:** For income or taxable years beginning on or after January 1, 1993, the Program Area hiring credit may reduce regular tax below TMT.

### L. CREDIT RECAPTURE

**References (Repealed Sections) 17053.11(f)(1); 17053.11(f)(3); 23623(f)(1); 23623(f)(3)**

Recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

- The first 270 days of employment (whether or not consecutive); or
- Ninety (90) days of employment plus 270 calendar days,

A “day of employment” includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

**NOTE:** Any increase in tax, due to credit recapture, cannot be offset by the current year hiring credit.

### ***Credit Recapture – Exceptions***

***References (Repealed Sections) 17053.11(f)(2); 23623(f)(2)***

Credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business; or
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

### ***Change in the Form of the Trade or Business***

***References (Repealed Sections) 17053.11(f)(2)(F); 23623(f)(2)(F)***

The employment relationship between the taxpayer and an employee shall not be treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues to be employed in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee shall not be treated as terminated.

## **M. RECORD KEEPING REQUIREMENTS**

For each qualified employee, documentation showing:

- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit

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## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 268 of 307

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- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why

**The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.**

**CHAPTER 23      PROGRAM AREAS SALES OR USE TAX CREDIT****A.      INTRODUCTION*****References (Repealed Sections) 17052.13(a),(b); 23612(a),(b)***

Program Areas converted to enterprise zones as of January 1, 1997. Prior to this date, taxpayers had to be certified by the California Trade and Commerce Agency (TCA) in order to be eligible to utilize the Program Area tax incentives. TCA could certify a taxpayer to take the hiring credit only or all five Program Area incentives. The type of certification can be determined from the certification letter.

Certification was generally valid for three years. After three years, the taxpayer would have to be re-certified. De-certification could occur if a company failed to meet the requirements.

A taxpayer certified by TCA to claim all five Program Area tax incentives, and operating in a Program Area, can take a credit for the sales or use tax paid or incurred in connection with the purchase of qualified property.

- In any year, individuals may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first \$1 million of qualified property.
- In any year, corporations may claim a credit equal to the sales or use tax paid or incurred on the purchase of the first \$20 million of qualified property. (See special rule for S corporations and shareholders in Section (h).)

No credit may be claimed for property purchased after the Program Area designation expires.

***Geographic Boundaries***

For a listing of program areas, refer to Chapter 1, Section (i). To verify an address, refer to Chapter 1, Section (c).

**B.      "TAXPAYER" DEFINED*****References (Repealed Sections) 17052.13(b)(1)(A); 23612(b)(1)(A)***

A "taxpayer" is a person or entity certified by TCA and engaged in a trade or business within a Program Area. A taxpayer does not qualify for the program area tax incentives, if they fail to be certified.

***Pass-Through Entities***

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S

corporation. The sales or use tax credit is allowed to the pass-through entity and passed through to the partners or shareholders.

**C. QUALIFIED PROPERTY****References (Repealed Sections) 17052.13(b)(2); 23612(b)(2)**

Qualified property must be used exclusively in the Program Area and is defined as:

- Machinery and machinery parts used for:
  - Fabricating, processing, assembling, and manufacturing a product.
  - The production of renewable energy resources.
  - Air or water pollution control mechanisms.

Generally, qualified machinery parts include those parts that are necessary for the operation of the machinery (e.g., a conveyor belt).

Excluded parts are those used to complete a certain job. They are typically expensed to cost of good sold or general expense accounts (e.g., specialized drill blades and oil utilized for routine maintenance work).

***Leased Property***

Taxpayers who acquire property by lease arrangement may qualify for the sales or use tax credit. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the sales or use tax credit. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

**D. CREDIT COMPUTATION – ASSET VALUE LIMITATION****References (Repealed Sections) 17052.13(a); 17052.13(b)(2); 23612(a); 23612(b)(2)**

The sales or use tax credit is equal to the amount of sales or use tax “paid or incurred” by the taxpayer in connection with the purchase and use of qualified property.

**Example:** Taxpayer spent \$53,750 to purchase machinery used in the taxpayer's business within a Program Area. The sales tax paid on the purchase is \$3,750. The sales tax credit is \$3,750.

Individuals, estates or trusts, partnerships, and limited liability companies (LLCs) taxed as partnerships may claim a credit on the sales or use tax paid or incurred

## CALIFORNIA FRANCHISE TAX BOARD

to purchase up to \$1 million of qualified property. Corporations may claim a credit on the sales or use tax paid or incurred to purchase up to \$20 million of qualified property. This limitation applies to each income or taxable year. (For S corporations and shareholders, refer to section (h).)

NOTE: Upon acquisition, if the taxpayer/purchaser was exempt from paying sales tax on the property under the California Revenue & Taxation Code (CRTC), then the taxpayer/purchaser did not pay or incur sales tax in connection with the purchase of the property to the extent of the exemption. Thus, the taxpayer/purchaser is not allowed to take the sales or use tax credit for the exemption amount.

### ***Use Tax Paid on Qualified Property***

#### ***References (Repealed Sections) 17052.13(c); 23612(c)***

If a taxpayer, operating within a Program Area, purchases property out of state and pays or incurs a use tax, the credit will be allowed only if qualified property of a comparable quality and price is not timely available for purchase in this state.

### **E. DEPRECIABLE BASIS**

#### ***References (Repealed Sections) 17052.13(e); 23612(e)***

Any taxpayer that elects to claim the sales or use tax credit, shall *not* increase the basis of the qualified property by the amount of the sales or use tax paid or incurred.

**Example:** Taxpayer spent \$53,750 to purchase machinery used in the taxpayer's business within a Program Area. The sales tax included in the purchase price was \$3,750. The basis of the property is \$50,000 (\$53,750 less \$3,750 sales tax).

### **F. BUSINESS INCOME ACTIVITY LIMITATION**

#### ***References (Repealed Sections) 17052.13(d); 17052.13(f)(1); 23612(d); 23612(f)(1)***

The amount of sales or use tax credit and hiring credit (see Chapter 22) claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's Program Area business income in any year. The Program Area business income is that portion of *worldwide* business income that is apportioned to the Program Area. Non-business income or loss is not included in the calculation of business income from the Program Area. Each taxpayer claiming the credit must compute the Program Area business income and resulting tax.

## CALIFORNIA FRANCHISE TAX BOARD

**Example:** Corp. A operates exclusively within a Program Area. In order to determine the amount of sales or use tax credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	\$2,000
Business expenses	<u>(17,000)</u>
Net Taxable Income	\$15,000

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	<u>(17,000)</u>
Net Business Income	\$13,000

To determine the sales or use tax credit allowable, the net business income is multiplied by the current tax rate (the tax rate prior to 1997 was 9.3%).

Net Business Income	\$13,000
x 9.3%	<u>x 0.093</u>
Tax associated with business income	\$1,209

In this example, the taxpayer can offset the tax of \$1,209 with the sales or use tax credit available (up to \$1,209).

**NOTE:** "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

### G. GENERAL PROVISIONS - INCOME APPORTIONMENT

**References (*Repealed Sections*) 17052.13(f); 23612(f)**

If a business is located within and outside of a Program Area, or in more than one Program Area, the taxpayer must determine the portion of the total business income that is attributable to each Program Area.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991- 1995 years and 1996 calendar year

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.



## CALIFORNIA FRANCHISE TAX BOARD

taxpayers), business income is apportioned to the Program Area by multiplying the *worldwide* business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For 1996 fiscal years, income or loss attributed to the Program Area is determined by multiplying *worldwide* business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor (double weighted), the denominator of which is four (4).

For income or taxable years beginning before January 1, 1991, income or loss attributed to the Program Area is determined by multiplying *worldwide* business income or loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

### (i) Property Factor – Income Apportionment

#### **References (Repealed Sections) 17052.13(f) 23612(f)**

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the Program Area* during the income or taxable year. The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

### (ii) Payroll Factor – Income Apportionment

#### **References (Repealed Sections) 17052.13(f) 23612(f)**

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the Program Area* during the income or taxable year. The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

### (iii) Sales Factor – Income Apportionment

The sales factor is a fraction. The numerator of the sales factor is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayers trade or business in the PA. The denominator is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 274 of 307

General rules regarding the double weighting of the sales factor are applicable.

**Example:** For the income year ending 12/31/95, Corp. A operates within and outside a Program Area. Total business income of \$13,000 needs to be apportioned to the Program Area. The following amounts apply to Corp. A's property and payroll:

Program Area Property	\$40,000
WW Property	\$100,000
Program Area Payroll	\$5,000
WW Payroll	\$10,000

Program Area Property/WW Property	=.40	
Program Area Payroll/WW Payroll	= <u>.50</u>	
	.90/2 = .45	Program Area Apportionment Factor

Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
Program Area Business Income	\$5,850
Current Tax Rate (Prior to 1997 – 9.3%)	<u>x 0.093</u>
Tax attributable to Program Area business income	\$544

### (iv) Apportionment – Combined Groups

For members of a combined group, the credit limitation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each Program Area taxpayer's separate Program Area payroll and property amounts (and sales as discussed in (g)) and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in (g)).

**Example:** For the income year ending 12/31/95, Parent corporation A has two subsidiaries, B and C. Corporations A and B operate within a Program Area. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income is \$1,000,000.

Business income apportioned to the Program Area was determined as follows:

	A	B	C	Combined
<u>Property Factor</u>				

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

# CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 275 of 307

Program Area	\$2,000,000	\$1,000,000	\$0	\$3,000,000
Property				
Worldwide Property				\$5,000,000
Apportionment %	40%	20%		60%
Payroll Factor				
Program Area	\$2,000,000	\$800,000	\$0	\$2,800,000
Payroll				
Worldwide Payroll				\$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Income				\$1,000,000
Program Area	\$450,000	\$200,000		\$650,000
Income				

## (v) Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within a Program Area and one outside the Program Area. Eighty percent (80%) of the S corporation's business is attributable to the Program Area.

**(NOTE:** This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located within the Program Area.

Ray and Mary Smith have the following 1996 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 276 of 307

---

Program Area business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

\*The Program Area business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's Program Area income is computed as follows:

Ray's Program Area salary (\$100,000 x 50%)	\$50,000
Mary's Program Area salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. (\$40,000 x 80%)	32,000
Program Area business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	<u>(1,000)</u>
Total Program Area income	\$151,000

Ray and Mary must compute the tax on the total Program Area income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*, the 1996 tax on \$151,000 is \$10,938. The \$10,938 is the first limitation on Program Area credits for the 1996 tax year. The second limitation on the credits is the *net tax* on all income.

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of Program Area income since they are not related to trade or business activities.

### H. S CORPORATION & SHAREHOLDER CREDIT AMOUNTS

**References 23803(a); (Repealed Section) 17052.13(b)(2) 23612(b)(2)**

S corporations operating within a Program Area may claim a credit on the sales or use tax paid or incurred to purchase up to \$20 million of qualified property. This limitation applies to each income year. The S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's Program Area income.

An S corporation's sales or use tax credit may reduce the Program Area tax at both the corporate and shareholder levels. One hundred percent (100%) of the Program Area credits are passed through to the S corporation shareholders. However, S corporation shareholders are only allowed to claim a credit on the sales or use tax paid or incurred on the purchase of up to \$1 million of qualified property of the S corporation for each taxable year. The shareholders claim their

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## CALIFORNIA FRANCHISE TAX BOARD

pro-rata share of this credit as recomputed under the California personal income tax law (Part 10).

The sales or use tax credit is first computed for the S corporation using the actual qualified acquisition costs not to exceed \$20 million. The amount of credit passing through to the shareholders is then computed using the actual qualified acquisition costs not to exceed \$1 million. This credit based on the \$1 million limitation is passed through to the shareholders based on their pro rata share. The Schedules K (100S) and K-1 (100S) must state the credit amounts allocable to the shareholders.

**Example:** Corp. Z, an S corporation, purchases \$2 million of qualified property, and elects to take the Program Area sales or use tax credit. Corp. Z is allowed to claim a sales or use tax credit of \$50,000 ( $\$2,000,000 \times 7.5\% \times 1/3 = \$50,000$ ). [Cost (not to exceed \$20,000,000) x sales tax rate x 1/3 S corporation credit limitation]

The corporation's two shareholders allocate between them a sales or use tax credit of \$75,000 ( $\$1,000,000 \times 7.5\% = \$75,000$ ). [Cost (not to exceed \$1,000,000) x sales tax rate]

### I. SALES OR USE TAX CREDIT AND THE HIRING CREDIT

**References (Repealed Sections) 17052.13(f) 23612(f)**

The amount of credit(s) allowed, in any income or taxable year, when a taxpayer is eligible to take both the sales or use tax credit and the hiring credit, is limited to the amount of tax imposed on the Program Area income. Thus, the taxpayer must aggregate the credits and limit the total amount of credits to tax imposed on the Program Area income.

### J. CREDIT USAGE AND CARRYOVER

**References (Repealed Sections) 17052.13(d) 17052.13(f) 23612(d) 23612(f)**

The portion of the credit that exceeds the "net tax"/"tax" for the income or taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

The aggregate amount of the Program Area credits, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the income or taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the Program Area, determined as if that income represented all of the income of the taxpayer.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 278 of 307

**Example:** A taxpayer has \$4,900 in Program Area credits (sales or use tax credit and hiring credit). Tax imposed on Program Area business income is \$4,700 and the taxpayer's overall "net tax"/"tax" is \$4,000. The maximum amount of credit is limited to the lesser of the tax on the Program Area business income, or the tax on the taxpayer's overall "net tax"/"tax".

Total Program Area credit	\$4,900
Tax on Program Area income	\$4,700
<b><u>First limitation:</u></b>	
Lesser of total credit or tax on Program Area income	\$4,700
<b><u>Second limitation:</u></b>	
Lesser of tax on Program Area income or "net tax"/"tax"	\$4,000
Maximum credit allowed:	
Lesser of <i>Program Area tax limitation</i> or "net tax"/"tax" limitation	<u>\$4,000</u>
Total Program Area credit	\$4,900
Maximum credit allowed	<u>\$4,000</u>
Carryover	\$ 900

If the taxpayer has any unused credits as of the date of the repeal of the Program Area tax incentives (income or taxable years beginning on or after January 1, 1997), the unused credits may continue to be carried forward until they are exhausted as enterprise zone incentives.

### K. CREDIT WILL NOT REDUCE CERTAIN TAXES

The Program Area sales or use tax credit cannot reduce the:

- minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- built-in gains tax (S corporations);
- excess net passive income tax (S corporation);
- alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- "net tax" or "tax" below tentative minimum tax (TMT) before January 1, 1993

**NOTE:** For income or taxable years beginning on or after January 1, 1993, the Program Area hiring credit may reduce "net tax" / "tax" below TMT.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 279 of 307

### **L. DEPRECIATION**

***References 18036 24916 (Repealed Section) 17052.13(e) 23612(e)***

Taxpayers electing to utilize the sales or use tax credit are not entitled to increase the basis of the property for which sales or use tax was paid or incurred in connection with the purchase of the property.

Depreciation of the capitalized cost of the asset may be claimed using any method of depreciation allowable beginning in the year the asset is placed in service.

NOTE: If the business expense deduction is taken for the same property, depreciation will start with the income or taxable year following the year in which the property is placed in service. The depreciation is calculated on the remaining basis *after* reduction for the sales or use tax credit and business expense deduction amounts.

### **M. CREDIT RECAPTURE**

There are no recapture provisions for the Program Area sales or use tax credit.

### **N. RECORD KEEPING REQUIREMENTS (REPEALED SECTIONS)**

To support the sales or use tax credit claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- the property purchased (such as serial numbers, etc.);
- the amount of sales or use tax paid or incurred upon purchase;
- the location where the property is used; and
- if purchased from a manufacturer located outside California, records to substantiate that property of comparable quality and price was not available for purchase in California.

**CHAPTER 24      PROGRAM AREA BUSINESS EXPENSE DEDUCTION****A.      INTRODUCTION*****References (Repealed Sections) 17265(a); 24356.3(a)***

Program Area designations expired as of January 1, 1997. Prior to this date, taxpayers had to be certified by the California Trade and Commerce Agency (TCA) in order to be eligible to utilize the Program Area tax incentives. TCA could certify a taxpayer to take the hiring credit only or all five Program Area incentives. The type of certification can be determined from the certification letter.

Certification was generally valid for three years. After three years, the taxpayer would have to be re-certified. De-certification could occur if a company failed to meet the requirements.

A taxpayer certified by TCA to claim all five Program Area tax incentives, and operating in a Program Area, could, for each income or taxable year, elect to treat 40% of the eligible cost of qualified property as a business expense rather than a capital expense.

The deduction was allowed for the income or taxable year in which the property was placed in service.

**NOTE:** For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs. The following Program Area discussion relates to income and taxable years beginning prior to January 1, 1997.

***Geographic Boundaries***

For a listing of program areas, refer to Chapter 1, Section (i). To verify an address, refer to Chapter 1, Section (c).

**B.      TAXPAYER DEFINED*****References (Repealed Sections) 17265(d)(4); 17265(e); 24356.3(d)***

For purposes of the Program Area business expense deduction, a *taxpayer* is a person or entity (other than an estate or trust) that conducts a qualified trade or business within a Program Area.

***Pass-Through Entities***



## CALIFORNIA FRANCHISE TAX BOARD

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

### ***Estates and Trusts***

#### ***References (Repealed Section) 17265(d)(4)***

Estates and trusts are not allowed to take the business expense deduction.

### **C. QUALIFIED PROPERTY**

#### ***References (Repealed Sections) 17265(a); 17265(d); 24356(a); 24356.3(c)***

Qualified property is property acquired by the taxpayer that is used exclusively within a Program Area and is defined as:

Machinery and machinery parts used for:

- fabricating, processing, assembling, and manufacturing;
- the production of renewable energy resources.
- Air or water pollution control mechanisms;
- property used as an integral part of a qualified business within a Program Area.

Qualified property must be purchased and placed in service *before* the date the Program Area designation expires, is no longer binding, or becomes inoperative.

### ***Leased Property***

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

### **D. PROPERTY NOT QUALIFIED**

#### ***References (Repealed Sections) 17265(d); 24356.3(c)***

The business expense deduction will not be allowed if the property:

- was transferred between members of an affiliated group;
- was acquired as a gift or inherited;

## CALIFORNIA FRANCHISE TAX BOARD

- was traded for other property;
- was received from a personal or business relation as defined by IRC Section 267, as modified by 17265(d)(2)(A);
- was received from a personal or business relation as defined by California Revenue & Taxation Code Sections 24427 through 24429, as modified by 24356.3(c)(2)(A);
- was received from a personal or business relation as defined by IRC Section 707(b); or
- is described in IRC Section 179(d).

### E. DEDUCTION AMOUNT

#### ***References (Repealed Sections) 17265(g); 24356.3(f)***

The maximum *deduction* the taxpayer may claim in any income or taxable year is determined by the number of years that have elapsed since the Program Area was designated, as follows:

Income or Taxable Years	Maximum Aggregate Cost	Maximum Deduction
Income or taxable year of designation and 1 <sup>st</sup> year thereafter	\$100,000	\$40,000
2 <sup>nd</sup> and 3 <sup>rd</sup> income or taxable year thereafter	\$75,000	\$30,000
Each income or taxable year thereafter	\$50,000	\$20,000

No deduction is allowed for property purchased after the expiration of the Program Area designation.

#### ***Partnerships***

##### ***References (Repealed Section) 17265(d)(6)***

In the case of a partnership, the percentage limitation (40%) of the aggregate cost of all qualified property shall apply at the partnership level and at the partner level.

#### ***Personal Income Tax Taxpayers-Married Filing Separate Repealed Section***

##### ***References (Repealed Section) 17265(b)***

In the case of a husband and wife filing separate returns for a taxable year, the applicable deduction shall be equal to one-half (50%) of the otherwise allowable deduction.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 283 of 307

### F. BASIS REDUCTION

The basis of the asset is to be reduced by the amount of the expense deduction claimed.

### G. INTERACTION WITH THE MANUFACTURER'S INVESTMENT CREDIT *References 17053.49(b)(1)(C); 23649(b)(1)(C)*

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

### H. ELECTION

*References (Repealed Sections) 17265(a); 17265(c); 24356.3(a); 24356.3(b)*

The taxpayer must make an election to treat the cost of qualified property as a business expense, on the original return filed for the income or taxable year the property is first placed in service. The election must specify the items to which the election applies and the portion of the cost taken into account for purposes of determining the deduction amount.

The election may not be revoked, unless the taxpayer has obtained the consent of the Franchise Tax Board.

#### ***Making the Election***

The election can be made by using:

- [Form FTB 3805Z](#) - Enterprise Zone/Program Area Deduction and Credit Summary.

#### ***Members of an Affiliated Group***

*References (Repealed Sections) 24356.3(c)(5); 24356.3(c)(6)*

For purposes of electing the business expense deduction, all members of an affiliated group shall be treated as one taxpayer. The deduction shall be properly apportioned among the members of the affiliated group.

An affiliated group is defined in IRC 1504 as modified by the California Revenue & Taxation Code, to replace "at least 80%" with "more than 50%" each place it appears in IRC 1504(a).

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 284 of 307

### I. DEPRECIATION

The basis (cost for depreciation purposes) of the property must be reduced by the amount allowed as a deduction. Depreciation of the cost of the property, less the amount deducted, may be claimed using any method of depreciation normally allowed, beginning with the income or taxable year following the year in which the property is placed in service.

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation allowed under IRC Section 179 / CRTC 24356 for the same property.

### J. CREATING A NET OPERATING LOSS

Unlike IRC Section 179, there is *no* statutory prohibition on the amount of business expense deduction amount that may create a net operating loss.

### K. ALTERNATIVE MINIMUM TAX

***References 17062; 23457***

The business expense deduction is *not* listed as a tax preference item.

### L. RECAPTURE

***References (Repealed Sections) 17265(h); 24356.3(g)***

The business expense deduction is subject to recapture (added back to income) if, before the *close of the second income or taxable year after* the property is placed in service, the property ceases to be qualified property (sold, disposed of, or no longer used exclusively within the Program Area trade or business).

To recapture the amount deducted, add to the current year income, the amount previously deducted for that property.

***Example:*** Corp. A purchases property on June 1, 1995 which qualifies Corp. A to take the Program Area business expense deduction. Corp. A's income year ends December 31 of each year. Corp. A disposes of the property August 5, 1997. The previous deduction is added to income in the 1997 tax year because the property was disposed of before the close of the second income or taxable year after the property was placed in service, 12/31/1997.

### M. CHECKLIST TO DETERMINE ELIGIBILITY FOR THE BUSINESS EXPENSE DEDUCTION

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# CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 285 of 307

Checklist Items	Yes	No
<p>Is the business qualified?</p> <ul style="list-style-type: none"> <li>Is a trade or business conducted within a Program Area? See the <i>Taxpayer Defined</i> section.</li> </ul>		
<p>Is the property qualified?</p> <ul style="list-style-type: none"> <li>Qualified property is tangible personal property that is subject to the allowance for depreciation. See the <i>Qualified Property</i> section.</li> <li>Is the property used exclusively within the boundaries of a Program Area?</li> </ul>		
<p>Is the correct deduction amount claimed?</p> <ul style="list-style-type: none"> <li>The limitation differs based upon the taxable or income year since the area designation. See <i>Deduction Amount</i> section.</li> <li>Verify purchase on invoices or receipts.</li> <li>Verify the date the property is placed in service.</li> </ul>		
<p>Was a timely election made?</p> <ul style="list-style-type: none"> <li>Election made on original return?</li> <li>Form FTB 3805Z – Enterprise Zone/Program Area Deduction and Credit Summary, or a separate statement attached to the return?</li> </ul>		
<p>Was the property acquired through a valid transaction?</p> <ul style="list-style-type: none"> <li>See the <i>Property Not Qualified</i> section.</li> </ul>		
<p>Was correct depreciation claimed?</p> <ul style="list-style-type: none"> <li>Basis must be reduced by the amount of the business expense deduction before depreciation is computed.</li> <li>IRC Section 179 expense or additional first year depreciation may not be claimed on qualified property for which the business expense deduction is claimed.</li> <li>A depreciation deduction on qualified property is not allowed in the same year the business expense deduction is claimed.</li> </ul>		
<p>Is the deduction subject to recapture?</p> <ul style="list-style-type: none"> <li>Was the property sold, disposed of or no longer used by the taxpayer in the Program Area, before the close of the second income or taxable year after the property was</li> </ul>		

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 286 of 307

placed in service?		
<ul style="list-style-type: none"><li>• Check the current location of the qualified property.</li><li>• Check the sale or disposal date of qualified property.</li></ul>		

### N. RECORD KEEPING REQUIREMENTS

To support the business expense deduction claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- the property purchased (such as serial numbers, etc.); and
- the location where the property is used

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**CHAPTER 25      PROGRAM AREA NET OPERATING LOSS****A.      INTRODUCTION**

***References 17276.1(a); 24416.1(a); Repealed Sections 17276.2(a); 24416.2(a)***

To claim program area incentives, taxpayers had to be certified by the California Trade and Commerce Agency (TCA). TCA could certify a taxpayer to take the hiring credit only or all five Program Area incentives. The type of certification can be determined from the certification letter. A taxpayer certified by TCA to claim all five Program Area tax incentives, and operating in a Program Area, may claim the Program Area net operating loss (NOL) deduction.

Certification was generally valid for three years. After three years, the taxpayer would have to be re-certified. De-certification could occur if a company failed to meet the requirements.

Taxpayers are required to annually report their income and expenses. Possible fluctuations in income and expenses may create substantial profits in one year, while losses in another. In years where expenses exceed income, a NOL occurs.

A qualified taxpayer (certified) engaged in a trade or business within the designated Program Area may elect to carry forward 100% of its NOL for a period of 15 years.

A Program Area NOL cannot be generated until the first taxable or income year beginning on or after the area has been officially designated as a Program Area.

NOTE: For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs. The following Program Area discussion relates to income and taxable years beginning prior to January 1, 1997. Relevant law sections are:

- 17276 - 17276.3
- 24416 - 24416.3

***Geographic Boundaries***

For a listing of program areas, refer to Chapter 1, Section (i). To verify an address, refer to Chapter 1, Section (c).

**B. QUALIFIED TAXPAYER*****References (Repealed Sections) 17276.2(a); 24416.2(a)***

For purposes of the Program Area NOL deduction, a qualified taxpayer includes a person or entity that is engaged in a trade or business within a Program Area.

Qualified taxpayers doing business in an area that was previously not a qualified area, but later designated as qualified, are allowed to utilize the special tax incentives for the taxable or income year beginning on or after the date the area receives designation as a program area.

***Pass-Through Entities***

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

**C. ELECTION*****References 17276.1(a)-(b); 24416.1(a) & (c); Repealed Sections 17276.2(e)-(g); 24416.2(e)-(g)***

Qualified taxpayers must make an election to claim the Program Area NOL. The election must be timely filed with the original return, and be for the income or taxable year in which the NOL is incurred. The election is irrevocable.

If the taxpayer is eligible to qualify for an NOL under more than one section (operation in more than one economic development area, new small business etc.), the taxpayer must choose which section to elect. Except for the loss incurred under the subdivision elected, taxpayers are prohibited from carrying over any other type of NOL from the same tax year.

Failure to elect to compute the NOL under section 17276.1 or 24416.1 will cause the NOL to be subject to the limitations and restrictions under section 17276 or 24416 (general NOL).

***Making the Election***

The election can be made by using:

- [Form FTB 3805Z](#) – Enterprise Zone/ Program Area Deduction and Credit Summary.

In addition, the form FTB 3805Z must be filed for each year in which the NOL deduction is taken.



## CALIFORNIA FRANCHISE TAX BOARD

### **D. PROGRAM AREA NOL COMPUTATION - GENERAL PROVISIONS**

***References 17276.1(a); 24416.1(a); Repealed Sections 17276.2(a)(2)(A); 24416.2(a)(2)(A)***

A Program Area NOL is the loss attributable to the qualified taxpayer's business activities within a Program Area, prior to the Program Area expiration date. Program Area NOLs are determined under IRC Section 172, as modified by the following CRTC Sections:

- 17276.1
- 17276.2
- 24416.1
- 24416.2

### **E. PROGRAM AREA NOL - LOSS ATTRIBUTED TO BUSINESS ACTIVITY**

***References (Repealed Sections) 17276.2(a)(2)(A); 17276.2(a)(2)(A)(i); 24416.2(a)(2)(A); 24416.2(a)(2)(A)(i)***

A Program Area NOL is the loss attributable to the qualified taxpayer's business activities within the Program Area prior to the Program Area expiration date. Non-business income and/or loss are excluded from the calculation of the Program Area NOL.

If a business is located within and outside of a Program Area, the taxpayer must determine the portion of the total business loss that is attributable to the Program Area.

- Business loss is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning after January 1, 1996 and before January 1, 1997 (1996 fiscal year taxpayers), business loss is apportioned to the Program Area by use of a four-factor apportionment formula. Worldwide business loss is multiplied by a fraction, the numerator of which is the property factor, payroll factor, and the double-weighted sales factor. The denominator is four (4).

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991- 1995 year taxpayers and 1996 calendar year taxpayers), business loss is apportioned to the Program Area by multiplying the worldwide business loss by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning before January 1, 1991, business loss attributed to a Program Area is determined by multiplying worldwide business loss by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

**(i) Property Factor – Loss Apportionment**

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the Program Area* during the income or taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

**(ii) Payroll Factor – Loss Apportionment**

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the Program Area during the income or taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

**(iii) Sales Factor – Loss Apportionment**

The sales factor is a fraction.

- The numerator of the sales factor is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayers trade or business in the Program Area.
- The denominator is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations

General rules regarding the double weighting of the sales factor are applicable.

## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 291 of 307

**Example** - Two-factor apportionment: For the income year ending 12/31/95, Corp. A operates within and outside a Program Area. Corp. A's business loss of \$13,000 needs to be apportioned to the Program Area. The following amounts apply to Corp. A's property and payroll:

Program Area Property	\$40,000
Worldwide (WW) Property	\$100,000
Program Area Payroll	\$5,000
WW Payroll	\$10,000

Program Area	= .40
Property/WW Property	
Program Area Payroll/WW	= <u>.50</u>
Payroll	

.40 + .50 = .90  
.90 / 2 = .45      Program Area  
Apportionment Factor

Business loss	\$(13,000)
Apportionment Factor	<u>x 0.45</u>
Program Area NOL	\$(5,850)

**NOTE:** The four-factor apportionment formula is as follows:

Zone income = (property, payroll, & sales factors / 4) x worldwide business income.

Property factor = zone property / worldwide property

Payroll factor = zone payroll / worldwide payroll

Sales Factor = zone sales / worldwide sales x 2

### (iv) Apportionment – Combined Groups

For members of a combined group, the Program Area NOL calculation will be based on the combined groups worldwide business loss (before CA apportionment). The numerator of the apportionment formula will be based on each Program Area taxpayer's separate Program Area payroll and property amounts (and sales as discussed in Section (e)(iii)), and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in Section (e)(iii)).

Example: For the income year ending 12/31/95, Parent corporation A has two subsidiaries, B and C. Corporations A and B operate within a Program Area. The combined group operates within and outside California and apportions its income

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

**CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 292 of 307

or loss to California using Schedule R. The combined group's business loss is \$1,000,000.

Business loss apportioned to the Program Area was determined as follows:

	A	B	C	Combined
<u>Property Factor</u>				
Program Area	\$2,000,000	\$1,000,000	\$0	\$3,000,000
Worldwide Property				\$5,000,000
Apportionment %	40%	20%		60%
<u>Payroll Factor</u>				
Program Area	\$2,000,000	\$800,000	\$0	\$2,800,000
Worldwide Payroll				\$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Loss				\$(1,000,000)
Program Area	\$(450,000)	\$(200,000)		\$(650,000)
NOL				

**(v) Apportioning for Personal Income Tax Taxpayers**

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within a Program Area and one outside the Program Area. Eighty percent (80%) of the S corporation's business is attributable to the Program Area. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the Program Area.

Ray and Mary Smith have the following 1996 items of California income and expense:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.

## CALIFORNIA FRANCHISE TAX BOARD

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary Loss	200,000
Program Area	
Business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from	
Schedule A	(2,000)

\*The Program Area business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's Program Area loss is computed as follows:

Ray's Program Area salary (\$100,000 x 50%)	\$50,000
Mary's Program Area salary (\$75,000 x 100%)	75,000
Pass-through ordinary loss from the S-Corp.	
(\$200,000 x 80%)	(160,000)
Program Area business expense deduction from	
the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	<u>(1,000)</u>
Total Program Area loss	<u>\$(41,000)</u>

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of Program Area NOL since they are not related to trade or business activities.

### F. PROGRAM AREA NOL LIMITED BY GENERAL NOL

**References 17276; 24416**

The Program Area NOL as computed under Section (e) is compared to the NOL computed under the general NOL provisions of section 17276 / 24416, *prior to the 50% reduction*. The Program Area NOL carryover is limited to the lesser of the Program Area NOL or the general NOL (prior to the 50% reduction). NOTE: If the program area NOL is limited by the general NOL amount, (prior to the 50% reduction), the amount can still be characterized as an program area NOL and allowed to be carried over at 100% for 15 years. An election must be made to characterize the NOL as an program area NOL.

## CALIFORNIA FRANCHISE TAX BOARD

**Example:** Corp. B incurred the following loss:

Income from business operations	160,000
Interest from investment which is unrelated to Corp. B's business operations	15,000
Expenses of business operations	<u>(189,000)</u>
<b>Net loss</b>	<b><u>(\$14,000)</u></b>

To determine the NOL carryover attributed to the Program Area business operations, the following must be done:

1. Determine NOL per CRTC 24416 (prior to 50% reduction);
2. Determine NOL per CRTC 24416.2 (remove non-business items)

The NOL carryover is limited to the lesser of item 1 or item 2 above.

1. CRTC 24416 "general" NOL - prior to 50% reduction  
Net loss of Corp. B (\$14,000)
2. CRTC 24416.2 Program Area NOL - exclude non-business income/loss  
Income from operations \$160,000  
Expenses of operations (189,000)  
Net loss of Corp. B (Program Area) (\$29,000)

Assume Corp. B operates entirely within the Program Area. Corp. B is allowed to carry over the lesser of the "general" NOL, or the Program Area NOL; in this case \$14,000.

Assume Corp. B conducts 40% of its total business operations in the Program Area as computed under Section (e). Because Corp. B only has 40% of its business operation in the Program Area, the \$29,000 business loss must be apportioned before comparing it to the "general" NOL. In this example, the Program Area loss is \$11,600 (\$29,000 x 40%). Corp. B is allowed to carry over the lesser of the "general" NOL, or the Program Area NOL; in this case, \$11,600.

### **G. CARRYOVER / CARRYBACK**

**References 17276.1(a); 24416.1(a); Repealed Sections 17276.2(a)(1); 24416.2(a)(1)**

For each income or taxable year, a qualified taxpayer, engaged in a trade or business within a designated Program Area, may elect to carryover 100% of its NOL. No NOL carrybacks are allowed.

The NOLs may be carried over to each of the 15 income or taxable years following the year of loss, or until exhausted, whichever occurs first. If a NOL

## CALIFORNIA FRANCHISE TAX BOARD

carryover remains at the time the Program Areas were repealed and converted to enterprise zones (effective 1/1/97), the carryover amount is now classified as an enterprise zone NOL carryover. If an enterprise zone NOL carryover remains after the enterprise zone designation has expired, the enterprise zone shall be deemed to remain in existence for purposes of computing the enterprise zone income limitation, and for purposes of allowing the enterprise zone NOL deduction.

### **H. GENERAL PROVISIONS-NOL CARRYOVER**

***References (Repealed Sections) 17276.2(a)(2)(B); 24416.2(a)(2)(B)***

The Program Area NOL carryover can only offset business income attributable to operations of the taxpayer within the designated Program Area. Non-business income/loss is excluded from the calculation of business income from the qualified area.

In the event a Program Area NOL carryover is allowable for any taxable or income year after the Program Area designation has expired, the Program Area will be deemed to remain in existence for the purpose of computing the business income limitation and allowing an NOL deduction.

#### **(i) Program Area Income - Attributed to Business Activity**

***References (Repealed Sections) 17276.2(a)(2)(A); 17276.2(a)(2)(B)(i); 24416.2(a)(2)(A); 24416.2(a)(2)(B)(i)***

If a business is located within and outside of a Program Area, the taxpayer must determine the portion of the total business income that is attributable to the Program Area.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

For income or taxable years beginning after January 1, 1996 and before January 1, 1997 (1996 fiscal year taxpayers), business income is apportioned to the Program Area by use of a four-factor apportionment formula. Worldwide business income is multiplied by a fraction, the numerator of which is the property factor, payroll factor, and the double-weighted sales factor. The denominator is four (4).

For income or taxable years beginning on or after January 1, 1991, and ending on or before December 31, 1996 (1991- 1995 year taxpayers and 1996 calendar year taxpayers), business income is apportioned to the Program Area by multiplying the worldwide business income by a fraction, the numerator of which

is the property factor plus the payroll factor, and the denominator of which is two (2).

For income or taxable years beginning before January 1, 1991, business income attributed to a Program Area is determined by multiplying worldwide business income by a fraction, the numerator of which is the property factor, payroll factor, and sales factor, the denominator of which is three (3).

**(ii) Property Factor – Income Apportionment**

The property factor is a fraction.

- The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the Program Area* during the income or taxable year.
- The denominator is the average value of all real and tangible personal property owned or rented and used or available for use during the income or taxable year *worldwide*.

Rented property is valued at eight (8) times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

**(iii) Payroll Factor – Income Apportionment**

The payroll factor is a fraction.

- The numerator of the payroll factor is the total compensation paid to the taxpayer's employees working within the Program Area during the income or taxable year.
- The denominator is the total compensation paid to employees working *worldwide* during the income or taxable year.

**(iv) Sales Factor – Income Apportionment**

The sales factor is a fraction.

- The numerator of the sales factor is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities occurring within the taxpayers trade or business in the Program Area.
- The denominator is composed of the gross receipts as defined under the provisions of R&TC 25134 - 25136, derived during the taxable or income year from transactions and activities related to worldwide operations



## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 297 of 307

General rules regarding the double weighting of the sales factor are applicable.

**Example** - Two-factor apportionment: For the income year ending 12/31/95, Corp. A operates within and outside a Program Area. Corp. A's business income of \$13,000 needs to be apportioned to the Program Area. The following amounts apply to Corp. A's property and payroll:

Program Area Property	\$40,000
Worldwide (WW) Property	\$100,000
Program Area Payroll	\$5,000
WW Payroll	\$10,000

Program Area Property/WW Property = .40

Program Area Payroll/WW Payroll = .50

.40 + .50 = .90

.90 / 2 = .45      Program Area  
Apportionment Factor

Business income	\$13,000
Apportionment Factor	<u>x 0.45</u>
Program Area income	\$5,850

**NOTE:** The four-factor apportionment formula is as follows:

Zone income = (property, payroll, & sales factors / 4) x worldwide business income.

Property factor = zone property/worldwide property

Payroll factor = zone payroll/worldwide payroll

Sales Factor = zone sales/worldwide sales x 2

### (v) Apportionment – Combined Groups

For members of a combined group, the Program Area business income calculation will be based on the combined groups worldwide business income (before CA apportionment). The numerator of the apportionment formula will be based on each Program Area taxpayer's separate Program Area payroll and property amounts (and sales as discussed in Section (e)(iii)), and the denominator will be based on the combined groups worldwide payroll and property amounts (and sales as discussed in Section (e)(iii)).

**Example:** For the income year ending 12/31/95, Parent corporation A has two subsidiaries, B and C. Corporations A and B operate within a Program Area. The

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**CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 298 of 307

combined group operates within and outside California and apportions its income or loss to California using Schedule R. The combined group's business income is \$1,000,000.

Business income apportioned to the Program Area was determined as follows:

	A	B	C	Combined
<u>Property Factor</u>				
Program Area	\$2,000,000	\$1,000,000	\$0	\$3,000,000
Property				
Worldwide Property				\$5,000,000
Apportionment %	40%	20%		60%
<u>Payroll Factor</u>				
Program Area	\$2,000,000	\$800,000	\$0	\$2,800,000
Payroll				
Worldwide Payroll				\$4,000,000
Apportionment %	50%	20%		70%
Average Apport. % (Property + Payroll Factors)/2	45%	20%		65%
Business Income				\$(1,000,000)
Program Area	\$(450,000)	\$(200,000)		\$(650,000)
Business Income				

**(vi) Apportioning for Personal Income Tax Taxpayers**

The following examples show the application of the apportioning rules to personal income tax taxpayers.

**Example:** Ray Smith is vice president of an S corporation that has two locations, one within an Program Area and one outside the Program Area. Eighty percent (80%) of the S corporation's business is attributable to the Program Area. (NOTE: This percentage was determined by the S corporation, using Worksheet V from the FTB 3805Z Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the Program Area.

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 299 of 307

Ray and Mary Smith have the following 1996 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary Loss	40,000
Program Area	
business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from	
Schedule A	(2,000)

\*The Program Area business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's Program Area income is computed as follows:

Ray's Program Area salary (\$100,000 x 50%)	\$50,000
Mary's Program Area salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp.	
\$40,000 x 80%	32,000
Program Area business expense deduction from	
the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses	
(2,000 x 50%)	<u>(1,000)</u>
Total Program Area income	\$151,000

**NOTE:** The standard deduction and personal or dependency exemptions are not included in the computation of Program Area NOL since they are not related to trade or business activities.

### I. NOL SUSPENSIONS

**References 17276.3(c); 24416.3(c)**

NOLs incurred by qualified taxpayers are *not* suspended for taxable or income years beginning in 1991 and 1992.

### J. S CORPORATIONS

**References 23802(d)(1)-(2)**

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## CALIFORNIA FRANCHISE TAX BOARD

For qualified taxpayers electing S corporation status *after* the designation of the Program Area, the qualified NOL attributed to the C corporation years cannot offset S corporation net income.

### **K. ALTERNATIVE MINIMUM TAX**

***References 17062; 23456***

Taxpayers claiming a Program Area NOL deduction must also determine their NOL for alternative minimum tax purposes.

### **L. FLOW-THROUGH LOSSES**

***References 17087.5; 17087.6; 17851; 23800; 24271***

The income and loss that will flow through to a shareholder, beneficiary, partner, or member, retains the same characteristics as it had with the pass-through entity.

The election (Section C) to claim an NOL must be made by the entity and each investor on their respective returns. The election by the entity to utilize the Program Area NOL does not extend to, or bind the investor to utilizing the Program Area NOL. Further, the investor may utilize the Program Area NOL if the entity utilized the general NOL provisions, or had no NOL. Each taxpayer must determine if they in fact have a NOL, and then decide whether the general or Program Area NOL will be utilized.

## **CHAPTER 26      PROGRAM AREA NET INTEREST DEDUCTION**

### **A.      INTRODUCTION**

#### ***References (Repealed Sections) 17231; 24384***

Repealed California Revenue & Taxation Code (CRTC) Sections 17231 and 24384 provided for the deduction of net interest income from loans made to a trade or business located solely within a Program Area. The net interest deduction is for interest payments received after the designation of the Program Area and before taxable or income years beginning before January 1, 1997.

For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs (see Section 17235 and 24384.5). Loans previously qualifying a creditor for the program area net interest deduction convert to the enterprise zone net interest deduction.

The following Program Area discussion relates to income and taxable years beginning prior to January 1, 1997.

#### ***Geographic Boundaries***

For a listing of program areas, refer to Chapter 1, Section (i). To verify an address, refer to Chapter 1, Section (c).

### **B.      QUALIFIED TAXPAYER**

#### ***References (Repealed Sections) 17231(a); 24384(a)***

For purposes of the program area net interest deduction, a qualified taxpayer includes a person or entity (creditor) that loans funds on or after the designation of the program area, to a qualified business/debtor and receives interest payments thereon. The loan advanced to the qualified business/debtor must also meet the requirements as discussed in Section (c).

The creditor does not have to be located in the program area to take advantage of the net interest deduction. Only the debtor needs to operate in the program area.

#### ***Pass-Through Entities***

In the case of any "pass-through entity", the determination of whether a taxpayer is a qualified taxpayer is made at the entity level.

**C. QUALIFIED DEBT**

***References (Repealed Sections) 17231(b); 24384(b)***

To claim the net interest deduction for creditors, the following requirements must be met at the time the indebtedness is incurred:

- The trade or business (*qualified business/debtor*) to which the loan is made, must be located solely within a Program Area;
- The indebtedness is incurred solely in connection with activity within the Program Area; and
- The creditor has no equity or other ownership interest in the debtor.

**NOTE:** Repealed Sections 17231(b) & 24384(b) require that the creditor have no equity or other ownership interest in the debtor at the time the loan is made. However, the CRTC does not provide for any limitation after the loan is made. For example, assume that two years after the qualified loan is made the debtor contacts the creditor to renegotiate the loan terms due to the debtor's poor financial condition. The creditor agrees to take an equity interest in the debtor in exchange for reducing the amount due from the debtor. Net interest received from the remaining portion of the qualified loan would still be deductible.

To claim the net interest deduction for creditors, the following requirements must be met annually:

- The qualified business/debtor that the loan was made to and interest payments are received from, must be conducting business in the program area.

Example: Two years after the qualified loan is funded, the qualified business/debtor moves their operations entirely outside of the program area geographic boundaries. The net interest deduction is no longer allowed because the trade or business is not located within the designated program area.

***Security/Collateral***

The statute does not require that the security or collateral for the loan be located in the Program Area. For example, a sole proprietor can use its personal residence as collateral for the Program Area business loan and the creditor would still be allowed the net interest deduction assuming all other qualifications are met.

***Definition of "Qualified Business/Debtor"***

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## CALIFORNIA FRANCHISE TAX BOARD

The definition of a *qualified business* in Section 7082 of the Government Code requires inquiry at the entity level. The business activity of the entity (entirely or a portion thereof as relevant) must be conducted within a Program Area.

### **Definition of a "Trade or Business"**

Black's Law Dictionary defines *trade or business* as follows:

*"Any business or professional activity conducted by a taxpayer, the objective of which is to earn a profit. The general test for determining whether a person is engaged in "trade or business" so as to be entitled to deduct expenses as trade or business expenses under the Internal Revenue Code is whether the taxpayer's primary purpose and intention in engaging in the activity are to make a profit."*

### **Definition of "Located Solely Within"**

**References (Repealed Sections) 17231(b)(1); 24384(b)(1)**

In order to claim the net interest deduction, the loan must be made to a qualified business *located solely within* a Program Area. Generally, one looks to the presence of tangible property in order to determine the place, site, or limits of a business. Intangible property by definition cannot be located by reference to physical presence. The presence of all of the qualified trade or business' payroll and tangible property within a Program Area would be a strong indication that they meet the test. The fact that sales are delivered by common carrier outside of the Program Area should not cause the borrower to fail the "*located solely within*" requirement.

## **D. NET INTEREST DEDUCTION – COMPUTATION**

### **Net Interest**

For purposes of determining the net interest deduction, *net interest* is gross interest received less related interest expense (cost of funds) and any other directly related expenses.

### **Gross Interest**

There may be substantial differences between *tax* and *book* accounting methods. Consequently, the amount of gross interest income included in the computation of net interest must be determined using the creditor's tax accounting method (i.e., the gross interest income included in the computation of net interest corresponds to the gross interest income included in the determination of taxable income). Gross interest income should not include items that are *not* in the nature of interest.

## CALIFORNIA FRANCHISE TAX BOARD

Interest is defined as an amount paid for the use or forbearance of money.

Gross interest may be determined by referencing the loan contract. A contract between a creditor and a qualified trade or business may include all of the following:

- A stated rate of interest;
- Points;
- Commitment fees (fees for entering into an agreement that obligates the lender to make funds available for an agreed period at a stated rate of interest - see Rev. Rul. 70-540)\*;
- Service fees (fee charged for processing a loan); and
- Escrow interest.

Analysis of each of the above items is necessary to determine which are in the nature of interest. For example, commitment fees and service fees should not be included in gross interest for purposes of determining the net interest deduction as they are fees earned when establishing the loan and are not monies paid for the use of the loaned funds.

Points are a charge by the lender, in addition to the stated rate of interest, to reflect the actual cost of borrowing money. Thus, points as here described, are for the use or forbearance of money and are considered to be interest. Escrow interest is interest from the date the loan is funded until 30 days before the borrower's first loan payment. Original issue discount (OID) is another form of interest. Stated interest, points, escrow interest, and OID are all items that may be included in gross interest for purposes of determining the net interest deduction.

**\*NOTE:** Revenue Ruling 70-540, 1970-2 CB 101 discusses the character of commitment fees from the lender's point of view. The commitment fee is a charge for agreeing to make funds available rather than for the use or forbearance of money, and therefore, is not interest. Other revenue rulings discuss commitment fees from the point of view of the borrower. To the extent of any discussion concerning the treatment of points by the lender, Rev. Rul. 70-540 was made obsolete by Rev. Proc. 94-29, 1994-1 CB 616; this does not effect its relevance in regards to commitment fees.

### ***Cost of Funds***

A reasonable amount of interest expense must be assigned to the interest income. One method of determining a reasonable cost of funds would be the following formula:

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## CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 305 of 307

$$\frac{\text{Interest Expense}}{\text{Funding Sources}} = \text{Cost of Funds}$$

Funding sources are equal to average liabilities plus owners' equity less average non-interest earning assets.

The ratio from the above formula would be multiplied by the average loan principal outstanding for the year. All amounts should be on a tax basis.

For example, assume the following is from the tax return of a financial institution:

Average liabilities and owners' equity	\$53,000,000,000
LESS: Average non-interest earning assets	<u>7,000,000,000</u>
Funding Sources	\$46,000,000,000
 Total Interest Expense	 <u>\$ 1,500,000,000</u>
Funding Sources	\$46,000,000,000 = 3.26%

Assume that an average principal amount of \$10 million was outstanding during the year for loans made to businesses within a Program Area. A reasonable amount of interest expense to assign to the loans is \$326,000 (\$10 million times 3.26%).

Taxpayers may also use an independent cost of funds index such as the prime index rate or the London Interbank Offered Rate (LIBOR), which is the rate banks use to place Eurodollars with one another in London. If an independent index is used, that index must approximate the taxpayer's cost of funds.

The annual report of many banks or savings and loan associations provides the average cost of funds. The net interest margin (the difference between interest income and interest expense) is usually of interest to shareholders and other users of the annual report. The net interest margin should be similar to that used for the calculation of the net interest deduction.

### ***Other Related Expenses***

"Net interest" is interest received less the cost of funds and direct expenses incurred in earning such interest. An example of a direct expense is commission paid to a loan representative. Expenses that are not directly attributable to the loan in question should not be subtracted for purposes of determining the net interest deduction.

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## CALIFORNIA FRANCHISE TAX BOARD

All reasonably identifiable direct costs applicable to acquiring or making a loan should be capitalized and written off over the life of the loan. The amortization method should reflect the nature of the loan. It would be reasonable to use straight line or principal reduction methods of amortization (see Rev. Proc. 94-29 for application of the principal reduction method).

### ***Non-Bank & Non-Financial Lenders***

Non-financial corporations and individuals usually do not have all of the various income and expense items referred to previously.

Generally, gross interest of non-bank or non-financial creditors will be the interest income as stated in the loan. For example, an individual creditor will generally avoid escrow interest by establishing the monthly due date of the loan as the day of the month the loan was funded, or the day escrow closed, whereas mortgages carried by a commercial lender generally have a common due date, i.e., the beginning of the month.

Related expenses, such as the cost of funds, must be determined in order to compute the deduction of net interest income. Non-bank or non-financial lenders who make loans to qualified businesses located solely within the program area may incur investment interest expense related to such loans. The interest tracing rules under Treas. Reg. 1.163-8T are appropriate for determining related interest expense for these taxpayers.

## **E. REPEAL OF PROGRAM AREAS**

For income and taxable years beginning on or after January 1, 1997, Program Areas were converted to Enterprise Zones (EZs) and are entitled to the benefits available to EZs (see Section 17235 and 24384.5). Loans previously qualifying a creditor for the program area net interest deduction convert to the enterprise zone net interest deduction.

## **F. RECORD KEEPING**

The qualified taxpayer/creditor should maintain records on each loan (loan agreements) for which a deduction of net interest has been taken that identifies or describes:

- the debtor,
- the debtor's location (at the time of indebtedness and annually),
- the debtor's mailing address,
- the purpose/use of the loan,

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## **CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
Economic Development Areas Manual (EDAM)

Rev.: November 2000  
Page 307 of 307

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- the stated interest,
- other items included in gross interest,
- any direct expenses associated with the loan, and
- any property securing the loan.

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